PORTABILITY OF PENSION PLAN BENEFITS; AND INVESTMENT OF PENSION PLAN ASSETS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

JULY 12, 1988

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PORTABILITY OF PENSION PLAN BENEFITS

TUESDAY, JULY 12, 1988

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to call, at 9 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
TUESDAY, JULY 5, 1988

PRESS RELEASE #21
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
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WASHINGTON, D.C. 20515
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THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING TO REVIEW THE PORTABILITY OF PENSION PLAN BENEFITS

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing to review the portability of pension plan benefits. The hearing is scheduled for Tuesday, July 12, 1988, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:00 a.m.

The Subcommittee's hearing will examine the components of pension benefit losses due to employment mobility, and evaluate current proposals to limit such losses. Specifically, the Subcommittee will address these issues focusing on the practices of pension plan administrators and the impact of the Federal tax rules which govern defined benefit and defined contribution pension plans.

Witnesses expected to appear at the hearing include the Department of Labor; the Department of the Treasury; the Congressional Budget Office; the General Accounting Office; and, interested Members of Congress. Other invited witnesses include organizations involved in the study of pension policy and representatives of public and private pension plans.

In announcing these hearings, Chairman Pickle made the following statement: "Last year, during conference discussions on the pension provisions in the Omnibus Budget Reconciliation Act, it was agreed that the Committee on Ways and Means would review the issue of pension portability. Earlier this year, Chairman Rostenkowski asked that the Subcommittee on Oversight conduct this review. I am pleased we will be looking at this important subject at this time. The portability of pension benefits has received increased attention from the public in recent years. A review by this Committee is appropriate and timely."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons wishing to submit written comments for the printed record of the hearing should submit six (6) copies by the close of business, Friday, July 29, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman PICKLE. I will ask the subcommittee to please come to order.

At our hearing this morning, the subcommittee will examine the effects of job mobility on a worker's pension benefits. We will consider the need for improving the portability of pension benefits, and we will evaluate various proposals for increasing pension portability.

The basic issues we will be considering are not new. This matter has been the subject of debate and controversy throughout my tenure in Congress. Indeed, it has received periodic consideration since at least 1965, when the Congress began the deliberations which led to the Employee Retirement Income Security Act of 1974. Nonetheless, it is important that we continue to examine the effect of our pension system on job mobility and retirement security.

In recent years, we have seen a major increase in the number of women and single parents participating in the work force, while continuing to meet the responsibilities of raising their families. We have seen a tremendous volume of merger and takeover activity which has forced workers to change their careers, often with little or no warning. Further, we have seen increasing recruitment of retired workers by employers unable to find young workers. Finally, as people live and work longer, we can expect the current trend toward increased job mobility to continue indefinitely. Therefore, we must be sure that our pension system continues to meet the needs of our changing work force and work place.

The impact of portability on the value of pension benefits will be particularly important for today's younger workers. As the baby boom generation ages and life expectancy increases, there will be unprecedented pressure on all retirement systems. In the past few years, we have made changes in the Social Security system to meet this challenge. But as we all know, Social Security benefits alone are not enough. It is imperative that individuals and employers establish retirement programs now and that these programs meet the needs of today's workers and employers.

To assist the subcommittee in its deliberations, we have asked the witnesses who will be testifying today to devote their considerable expertise toward examining the problem and the implications of changes which might be made. The subcommittee does not expect to arrive at answers to all the questions raised concerning pension portability. Rather, we hope to explore all the various possibilities and issues in a forthright and positive manner.

Before we proceed, I would recognize our colleague, Mr. Schulze, for any opening statement he might make. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I join you in opening today's hearing on pension portability. The term "pension portability" has no precise definition. It generally refers to the ability of a participant in a qualified pension plan to transfer the assets and service credits related to his pension plan as he moves from one employer to another over the course of his working years.

Portability has become an increasingly attractive feature in recent years. There are several reasons for the growing attention to portability. First, our work force is becoming very mobile. Work-

ers no longer spend a lifetime with one employer the way they may have a generation ago.

Second, the Tax Reform Act of 1986 reduces the period of time for a person to vest in his pension benefits. The old 10-year cliff on vesting is being replaced by a 5-year cliff. This means more workers will have vested benefits which they may wish to transfer when they change jobs.

The purpose of today's hearing is to identify the major issues involved in promoting pension portability. There are two important features. First, asset portability refers to the transfer of the assets related to a person's vested pension benefits. Current law allows for asset transfers in many situations. I am anxious to learn what more needs to be done to promote the transfer of assets. An important policy question in this analysis is whether asset transfers should be voluntary or whether the law should be tilted in the direction of mandatory transfers.

The second major issue involves the transfer of service credits between and among pension plans. This is a challenging and complex issue. The only institutions which currently allow for the transfer of service credits involve multiemployer plans and controlled groups. Except for these special situations, there is little portability of service credits.

Mr. Chairman, part of the difficulty in promoting pension portability stems from the divergence of our voluntary private pension system. For years we have encouraged a diverse independent system of private pension plans. I hope that we can retain that independent spirit and imagination as we explore pension portability. We need to strike a careful balance between promoting portability and fostering a strong private pension system.

Mr. Chairman, I look forward to hearing today's witnesses, and I join you in welcoming them.

Chairman PICKLE. Thank you, Mr. Schulze.

Now, our first panel this morning will consist of GAO and the Congressional Budget Office, but before we proceed with that first panel, I am going to ask our colleague, Congressman Jim Jeffords of Vermont, to make any statement he might care to make. We are glad to have you here, Mr. Jeffords.

I point out to the committee that Mr. Jeffords has shown considerable interest in the subject of pension portability, perhaps more so than any Member of the Congress. Last year, when we were considering the matter of pension solvency, at one point we considered seriously whether we could include pension portability in the package. But, the legislation had been already approved and too far advanced. We told Mr. Jeffords we would bring up the subject this year.

I know he has been active on the subject and maintains a keen interest in this subject. While the hearing is not on the measure you introduced, it is on the question of mobility and portability, and, therefore, we are pleased to hear from you. Do you have a written statement, or are you just going to make a verbal statement?

STATEMENT OF HON. JAMES M. JEFFORDS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VERMONT

Mr. JEFFORDS. I have a written statement I will ask to be made a part of the record.

Also, I would like to summarize and to give some brief reading of parts of that statement in order to familiarize the committee with the bill which we discussed last year and with one change which has been made at the request of the administration.

First, I want to thank you for this hearing. As you did state, we went over this type of proposal extensively last year. Unfortunately, as you know, things kind of got a little confused at the end of the budget reconciliation conference, and we didn't have time to fully analyze it. I appreciated your statement then that you would have a hearing and listen to me, and I appreciate that very much.

I would also point out the Senate Finance Committee is holding a hearing on my bill, H.R. 1961, and other bills, and I will be testifying this morning before that committee also.

I want to commend both you, Mr. Chairman, and Mr. Schulze for your efforts, and also Congressmen Matsui, Chandler, and Feighan for their work. We have worked closely with them on trying to come up with a proposal. Since ERISA's passage, we have had nearly 14 years of talk on what to do about pension portability. We have talked about all sorts of complicated matters of credits, subsidies and other approaches. Our Committee on Education and Labor proposal, H.R. 1961, tries to simplify the situation. It says let's preserve the assets and move them into a portability vehicle so those assets can be invested and accumulated for future use in retirement.

As you and Mr. Schulze both pointed out, there is need for action now. The demographics of the work force are changing dramatically, more and more of the population is becoming aged, and the workers-to-retired ratio is declining to a desperate level. Therefore, we need to have present funded pensions in order to help alleviate the demands upon our workers of the future. We see increased mobility due to the fact our whole economic situation is changing, to the types of jobs available, and to the number of job shifts which are increasing rapidly. This fact will be demonstrated again tomorrow when we discuss plant closing legislation.

Also, as pointed out by Mr. Schulze, we have a new 5-year vesting rule which is going into effect, and we ought to be ready for the increased need for portability which will be presented there.

I would also bring to the committee's attention the DOL ERISA Advisory Council report of March 1988, which effectively endorsed the principles which are contained in my proposal. The OTA report, Technology and the American Transition, of May 1988, also speaks favorably toward our principles.

I would like to briefly discuss the provisions of the bill. The proposal encourages a form of voluntary portability from existing tax qualified pension plans. First, the current law prohibition on the direct transfer of employee contributions from pension plans to IRAs is removed. The Pension Portability Act would permit all or a portion of a terminated employee's benefit under a qualified plan,

including the employee's own aftertax contributions, to be transferred tax free directly from the plan to a portable pension plan.

Second, unless pensions are paid in annuity form, the direct transfer from qualified plans to a portable pension plan would become the presumptive form of distribution. And that gets to the issue Mr. Schulze pointed out, which is just what to do here, and we changed this at the request of the administration to make it presumptive rather than mandatory to have such a transfer. Not all plans, but at least those qualified plans that allow for single sum distributions, would have to provide employees who are eligible for a distribution from the plan with an option to transfer the benefits. Such sums would be paid to a portable pension plan in a direct trustee-to-trustee transfer.

A plan would be allowed to provide this portability transfer option as the only option or as one of other distribution forms, including the joint and survivor form as under current law. Also, if the qualified plan provides, employees would be permitted to elect out of the portability transfer option and receive their benefits in another form allowed under the plan. To encourage the employee and the employee's spouse to utilize the tax-free portability transfer, the plan must provide an explanation of the possible adverse tax consequences of not taking such a transfer.

Third, plan sponsors would be allowed to reduce their record keeping burdens by transferring the pensions of terminating employees to portable plans. Thus, the portability of pensions in any amount would be encouraged by permitting plans, without obtaining employee or spousal consent, to make such transfers. This procedure would be allowed because the receiving portable plan would be treated as a transferee plan that protects any spouse and provides a core set of distribution options.

Finally, the portability of pension amounts between plans would be improved. Direct trustee-to-trustee transfers would always be allowable among portable plan IRAs, and as under current law, previous rollovers or transfers from qualified plans to IRAs, which are separately accounted for, may be transferred back to qualified plans of the same type.

I would also point out the budget impact is well within the guidelines which make passage of this bill allowable. The CBO estimates, in view of the delayed effective date, that there would be no budget impact through fiscal year 1991, and there would be less than a $50 million impact in the years 1990 through 1993.

I would also point out that the revenue impact is only temporary, that the income accumulating in portable plans is merely deferred and that eventually the revenue obtained from future distributions would offset the level of future deferrals.

Mr. Chairman, I thank you again for the courtesy of having me testify before you today. I have a number of other issues, both in my Agriculture and Labor Committee this morning. I appreciate the opportunity to testify. I would be happy to answer any questions you might have.

[The statement of Hon. James M. Jeffords follows:]

STATEMENT OF HON. JAMES M. JEFFORDS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VERMONT

First, let me commend you and your Committee for holding today's hearings on the timely subject of pension portability; a subject, I might add, that transcends the obvious and important gains in retirement income security that can accrue to America's workers and their families.

In a broader context, the legislative approach I will present to the Committee for its consideration today also offers great potential for increasing national savings and capital formation and for addressing the issues of worker dislocation, mobility, and competitiveness.

During the enactment of ERISA nearly fourteen years ago, our two Committees and the corresponding two Committees of jurisdiction in the Senate were charged to study alternative means of enhancing pension portability and expanding pension coverage. Over the last decade and a half the House Committee on Education and Labor, on which I serve as Ranking Member, has held extensive oversight and legislative hearings on these and other employee benefits subjects with the view towards developing a national retirement income policy.

As stated in my testimony before this Committee almost three years ago to the day, it is not only my view and that of my Committee, but also the consensus of several Presidential commissions and other private and governmental study groups on retirement that a long term framework should be fashioned in this most critical area of domestic policy. At that time it was clear that several themes stemming from these hearings and studies appeared to have a rather broad consensus among business, labor, and employee/retiree groups. Briefly stated they encompass the topics of pension portability, pension coverage, and what I will term "pension preservation." These three topics remain as choice candidates for inclusion in any revised retirement policy structure which seeks to improve on the efficiency of the current framework serving to supplement Social Security, that is, employer plans and individual retirement savings. That framework is essentially a voluntary one, and I believe that we in Congress must be careful to recognize that element as we fashion our intended improvements.

Since I last testified before you there has been a strengthening of the consensus for an improved retirement income policy framework, especially as the details of this framework have been refined. To illustrate, I would call to the Committee's attention the degree of unanimity accompanying the recent recommendations of the Advisory Council established under ERISA. In March the business, labor, retiree, and public representatives on this Council recommended a change in law requiring private pension plans that permit lump sum distributions to transfer such amounts to financial intermediaries. In general, the Pension Portability Act of 1988 as reported by the Committee on Education and Labor on April 28th incorporates just such a feature as the presumptive form of distribution for terminated employees who receive distributions prior to retirement.

The ERISA Advisory Council also made a number of other positive recommendations regarding portability and expansion of pension coverage, including a provision to allow employees who are not otherwise covered under a pension plan to request of their employer that a salary-reduction SEP be established for their contributions. As to this last innovative feature, I'd like to recognize that your Committee colleagues,

Representatives Bob Matsui and Rod Chandler, had the foresight to include just such a provision in the pension portability legislation they've introduced.

At this point I would like to briefly describe the features of the Pension Portability Act of 1988 (H.R. 1961) as they were reported by the Committee on Education and Labor (House Report 100-676, Part 1). The reported bill has also been jointly referred to your Committee on Ways and Means for legislative consideration. I should point out that the legislation has been developed on a bipartisan basis, is cosponsored and supported by our Committee and Subcommittee Chairmen and Ranking Members, and has been approved unanimously by the full Committee on two separate occasions. As reported on April 28th, H.R. 1961 also reflects several changes to the pension portability provisions as they were passed by the House last year under budget reconciliation. The changes were made to conform the provisions as closely as possible with specifications that had been suggested by the Administration during the budget reconciliation conference.

As revised, this legislation containing the "portable pension plan" concept is intended to directly address the needs of our increasingly mobile labor force and to better preserve current pension plan asset accumulations of over $2 trillion for the payment of retirement benefits.

Today too much of this $2 trillion in assets, which NBC News labeled "The Biggest Lump of Money in the World," is being cashed-out, thus reducing future retirement income security and our pool of national savings and increasing the burdens on Social Security. From another perspective, our increasingly mobile labor force, while generating a more frequent turnover of pension assets, is demanding a more attractive pension portability vehicle than currently exists. The Pension Portability Act meets these dual and seemingly conflicting chalienges by permitting portable pension plans (i.e. individual retirement plans and SEP's) to be set up by private sector investment managers in order to receive, on a tax-free basis, those employer plan distributions that would otherwise be cashed-out.

In several specific ways, the proposal encourages a form of voluntary portability from existing tax-qualified pension plans. First, the current law prohibition on the direct transfer of employee contributions from pension plans to IRA's is removed. The Pension Portability Act would permit all or a portion of a terminated employee's benefit under a qualified plan, including the employee's own after-tax contributions, to be transferred tax-free directly from the plan to a portable pension plan.

Secondly, unless pensions are paid in annuity form the direct transfer from qualified plans to a portable pension plan would become the presumptive form of distribution. Not all plans, but at least those qualified plans that allow for single-sum distributions would have to provide employees who are eligible for a distribution under the plan with an option to transfer their benefits. Such sums would be made to a portable pension plan in a direct trustee-to-trustee transfer. A plan would be allowed to provide this portability transfer option as the only option or as one of other distribution forms, including the joint and survivor form as under current law. Also, if the qualified plan provides, employees would be permitted to elect out of the portability transfer option and receive their benefits in another form allowed under the plan. To encourage the employee and the employee's spouse to utilize the tax-free

portability transfer, the plan must provide an explanation of the possible adverse tax consequences of not taking such a transfer.

Thirdly, plan sponsors would be allowed to reduce their recordkeeping burdens by transferring the pensions of terminating employees to portable plans. Thus, the portability of pensions in any amount would be encouraged by permitting plans, without obtaining employee or spousal consent, to make such transfers. This procedure would be allowed, and the current $3,500 restriction would be eliminated, because the receiving portable plan would be treated as a transferee plan that protects any spouse and provides a "core" set of distribution options.

Finally, the portability of pension amounts between plans would be improved. Direct trustee-to-trustee transfers would always be allowable among portable plan IRAs, and as under current law, previous "rollovers" or transfers from qualified plans to IRAs, which are separately accounted for, may be transferred back to qualified plans of the same type.

For several reasons I believe it critical that this Congress move expeditiously on these pension portability and asset preservation provisions I've just described. The recent number of terminations of overfunded pension plans has led in many cases to the lump-sum cashout of vested benefits, thus undermining the future retirement income security of employees choosing cash rather than annuities. The adoption of these provisions would help assure that such sums continue to be invested for retirement purposes. Also, the Tax Reform Act's amendments shortening ERISA's vesting provisions from 10 to 5 years will undoubtedly result in a further acceleration in both the voluntary and mandatory lump-sum cashout of vested benefits when short-service employees terminate their employment. Given that plans' vesting provisions must soon be brought into conformance with the Tax Reform Act, it is crucial that the portability legislation be enacted now so that the pension asset preservation provisions can be made effective in a timely manner.

Transcending these short-term concerns and from a more long term perspective, the portable pension plan concept under H.R. 1961 is a key element in furthering spousal pension protection; in furthering the expansion of pension "buy-back" features for teachers, engineers, and other mobile employees; and in encouraging the payment of pension accumulations in annuity-like form to supplement Social Security.

In general, IRAs (including SEP's) would serve as the portability vehicle for benefit transfers from qualified plans. Such benefit transfers could consist of both taxable and non-taxable benefits subject to appropriate reporting requirements. Separate accounting of such amounts, including earnings thereon would make the amounts eligible to be transferred back to qualified employer plans.

In addition, the IRA portability vehicle would be subject to the Retirement Equity Act spousal protection rules as though they were defined contribution plans of the profit-sharing type. By treating the portability vehicle as a transferee plan, the spouse or other beneficiary designation under the qualified plan would continue to be effective with respect to any benefits transferred.

Lastly, the IRA portability vehicle would have to make available a number of core distribution forms -- for example, lump sums, joint and survivor and single life or quasi-annuity forms, and ten year installment forms.

In addition to pension portability and pension asset preservation, my Committee colleagues and I consider the widespread lack of pension coverage to be one of the most serious problems remaining to be addressed by ERISA. About one-half of this Nation's recent retirees must meet their retirement needs without the benefit of employer-sponsored or other individual retirement savings. Even today, far too many of the Nation's workers must rely on Social Security alone for their retirement income security.

H.R. 1961 begins to address this need by reducing the administrative and cost barriers currently hindering employers from establishing plans and making contributions. By establishing portable pension plans under which employers and employees may make contributions as circumstances permit without having a continual and annual obligation to do so, the bill gives recognition to the fact that one of the major reasons that some small employers are reluctant to establish plans is a concern that they will be unable to make the annual required contribution.

Also, by removing the restriction on the size of the employer who can enroll their uncovered workers under a salary-reduction SEP, the legislation intends to simplify the administration and operation of SEP's, thus encouraging the expansion of pension coverage. Under a new simplified formula, employers would be able to make contributions on any combination of a percentage-of-compensation or fixed-dollar-per-participant basis. Employees would then be able to contribute to the plan on a salary-reduction basis in any amount up to the employer's contribution. Employer and employee salary-reduction contributions would be subject to the limitations on contributions under existing law. Besides being an administratively simple and attractive means for employers to establish pensions for their employees, it has been demonstrated that employees are more likely to contribute and save if employers lead the way and the amounts contributed do not show up in an employee's W-2 wages.

H.R. 1961 offers additional encouragement for the establishment of portable pension plans by clarifying and simplifying the application of ERISA to such plans. In this connection the ERISA funding rules would be made inapplicable to SEP's and other IRA pension plans. To eliminate the inconsistency of SEP rules under current law, ERISA would be conformed to the vesting, participation, and distribution rules applicable to SEP's under the Internal Revenue Code.

In summary, Mr. Chairman, as a key element of the national retirement income policy advanced by my Committee on Education and Labor, the Pension Portability Act is designed to improve retirement income security and address issues of worker dislocation, mobility, and competitiveness by enhancing pension investment choice, national savings and capital formation. I would observe that these goals are also consistent with the employee pension plan policies adopted pursuant to the Tax Reform Act of 1986 and its ERISA predecessor.

Because of the long and careful study we've made of the pension portability and pension coverage issues, I believe the Congress can now take these significant steps while at the same time maintaining the delicate balance needed to protect employee

interests and preserve the best features of both defined benefit and defined contribution plans under our private pension system.

In conclusion, I look forward in the days ahead to working closely with you, Mr. Chairman, the other members of this Committee, the Administration, and other interested parties so that by means of the early enactment of the Pension Portability Act of 1988, we can begin moving towards the goal of increasing pension coverage, portability, and retirement savings.

Chairman PICKLE. Mr. Jeffords, I thank you.

What is the number of your bill?

Mr. JEFFORDS. H.R. 1961.

Chairman PICKLE. I know that that bill has been referred to our committee, and we have not had a chance to bring it up specifically. We have agreed that we will act on that bill, and I am sure that is the chairman's intent, and he will certainly have my cooperation.

You were certainly cooperative last year. Has your bill passed the Education and Labor Committee?

Mr. JEFFORDS. Yes, it has. It passed the full committee unanimously on April 28.

Chairman PICKLE. All right. I think, as I recall it, the gist of your bill's function, at the beginning part, is sort of an IRA rollover.

Mr. JEFFORDS. Basically, that is true; a direct trustee-to-trustee transfer to be more precise. There are other functions along with it.

Chairman PICKLE. Does your bill say that the IRA is optional, or is it just available, or is it a procedure that would automatically apply?

Mr. JEFFORDS. It provides that there would be a presumption that the funds would be directly transferred into an IRA portable pension plan. However, if the plan provides for other options, that is allowable, including a lump sum distribution, but it would depend upon whether the plan allows the terminating employee to choose another option.

Chairman PICKLE. Would your plan provide, assuming it rolled over and that choice was made, that the IRA would have to be kept for a certain period of time or that if it were cashed, there would be any kind of penalty applied to it?

Mr. JEFFORDS. Well, you have the penalty which you presently have in the law, the 10-percent penalty would apply at any time it was cashed out before age 59½, but it could also be held indefinitely, or it could be rolled into a new plan, depending upon the situation.

Chairman PICKLE. I am not specifically familiar with the bill in detail. Overall, though, I think it is a good positive approach to an improvement in the pension program.

I would comment, though, that I don't know we are ever going to find the answer to portability. When you have a number of employers and changes made, it is going to be difficult to pass that along, and yet this would be an improvement, and I think we ought to consider it seriously, or any other improvement we can find, because it is a serious question.

So, I, as one individual, I express my appreciation for the bill you have introduced. We will work with you, and I hope we will have some direction from the full committee soon, because I know you have spent a great deal of time studying this question.

Mr. Schulze, any questions or comments?

Mr. SCHULZE. Just very briefly, Mr. Chairman.

One of the questions I asked in my opening statement was: What do we do with underfunded defined benefit plans? Do you have any suggestions on that?

Mr. JEFFORDS. I wish I did. We, of course, with this particular bill do not go into the issue of underfunded defined benefit plans. We are hopeful we do not in any way discourage the full funding of benefit plans by providing this option and don't believe it would impact negatively upon that aspect. But we have not tried to deal with that issue in this particular bill.

Mr. SCHULZE. I am aware of that, but I was wondering whether you had any thoughts on what should be done. That is a crucial issue.

Mr. JEFFORDS. I agree it is. I think we made some significant improvements last year in the underfunding aspects of pensions, defined benefit plans, and I have not sat down and looked for a new direction this year, but I would be most happy to do so at some time in the future.

Mr. SCHULZE. Of course, I guess I am mainly asking with regard to pension portability because I believe it is an issue we have to be aware of if we are going to pass legislation. Would you be more inclined to tilt toward mandatory portability, or would you tilt the other way and make it totally voluntary?

Mr. JEFFORDS. Well, our original proposal was to essentially make the transfer mandatory, but only if the pension plan voluntarily made a distribution available to the employee at job termination. However, working with various groups and with the administration, we agreed to utilize what we refer to as a presumptive system, and that is that the distribution would be in the form of a trustee-to-trustee transfer, unless the plan provides otherwise. Thus, the assets would move into a new tax-deferred pension vehicle, and then hopefully that would be enough of an incentive or at least would increase substantially the number of assets that would stay within the pension system.

As I said originally, our proposal would have made it a mandatory transfer, but out of deference to the administration and the groups that were involved, we ended up with a presumptive form.

Mr. SCHULZE. If, as you originally proposed, we had mandatory portability, what then were you planning to do with underfunded defined benefit plans?

Mr. JEFFORDS. I may have misunderstood your question. We never mandated that the employer had to give the assets over, but we mandated that if in the first instance there was a lump sum distribution offered, it would have to go to another pension or portable plan trustee.

I will be happy to respond to your question more fully in writing.

Mr. SCHULZE. Mr. Chairman, I would like to thank our colleague for his presentation and his interest in this issue. We appreciate his testimony.

Chairman PICKLE. Mr. Jeffords, we thank you. We know of your keen interest in this subject, we know we need to do more. I assume this committee would also be actively involved in this question soon, and I will make inquiry of the chairman how he wants to handle it. We certainly will cooperate.

Mr. JEFFORDS. I appreciate your consideration, Mr. Chairman.

[The following letter was subsequently received:]

JAMES M. JEFFORDS
VERMONT CONGRESSMAN

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July 19, 1988

Honorable Richard T. Schulze
2369 Rayburn House Office Building
Washington, DC 20515

Dear Dick:

This is a follow up on the questions you asked during Tuesday's Ways and Means Subcommittee on Oversight hearing on pension portability.

You asked whether I favored a "mandatory" or "voluntary" approach to pension portability in connection with defined benefit pension plans. As I now understand the meaning that you attribute to the term "mandatory," I would agree that extreme care would have to be taken to preserve the funding status of defined benefit plans if such plans were mandated to transfer (or employees were entitled under law to demand) the present value of vested benefits (or cash them out) at the time of job termination. I fully understand your concern and personally think that additional funding safeguards would have to accompany any changes in law mandating such far-reaching changes.

I would like to assure you, however, that the Pension Portability Act of 1988 (H.R. 1961), both as introduced and as reported by the Committee on Education and Labor on April 28th, contains a "voluntary," but not a "mandatory" form of pension portability. As I mentioned at the hearing, H.R. 1961, upon introduction, did contain a provision whereby an automatic transfer to a portable pension plan IRA would take place, but only in the case in which the pension plan already contains a lump-sum distribution option and the lump-sum option is exercised under the terms of the plan for a terminated employee.

This latter approach was modified in Committee to make the direct trustee-to-trustee transfer the "presumptive" rule, and only under those pension plans, including defined benefit plans, which voluntarily provide for single-sum distributions. This change is in conformance with the Administration's specifications and in concurrence with the Profit Sharing Council and other interested parties.

Therefore, I would like to emphasize that there are no provisions in H.R. 1961 that would mandate that distributions be made from defined benefit pension plans, whether underfunded or otherwise. To the contrary, it is only in the case where such plans already have lump-sum distributions that the transfer applies, and this would have the positive effect of helping keep these pension amounts for retirement purposes.

It has been my observation that defined benefit plans, particularly underfunded ones, have other reasons why they do not generally provide lump-sum distributions; and most do not, with perhaps minor exceptions involving small amounts. As you stated at the hearing, in most cases defined benefit plans are established to encourage continued employment with the plan sponsor; this is why defined benefit plans usually pay deferred vested pensions to employees who terminate prior to normal or

early retirement age. Underfunded plans also avoid paying large distributions because of their concern over the degree of plan asset liquidity that may be required if lump sums were provided. Additionally, underfunded plans will be further discouraged from paying lump sums as a result of the new ERISA funding rules enacted last year under the Pension Protection Act. These rules require all or a large share of any lump sum to be contributed back to the plan within a short period of time.

For these and other reasons, I do not believe the pension portability transfer provisions of H.R. 1961 will cause underfunded defined benefit plans to change their current practice of paying annuities or otherwise cause plan sponsors to lessen plan funding. Therefore, I believe it safe to say that H.R. 1961 will not have any noticeable impact on the ERISA Title IV termination insurance program.

On the other hand, I would note that the Administration testimony indicated a preference for a change in ERISA which would curtail the current law ability of underfunded defined benefit plans to provide lump-sum distributions where plan insolvency might result. If abuses of this privilege under current law are shown to threaten the financing of the Title IV single employer program and the solvency of the PBGC, then of course I would agree with appropriate steps that you and your Committee may suggest to prevent such abuse. But I would again like to state my belief that this is a problem that may exist under current law and which will not be caused or exacerbated by the enactment of H.R. 1961.

I trust that this explanation is responsive to the questions you raised at the hearing. I can assure you that I remain ready in the few legislative days remaining in this Congress to work with you, Chairman Pickle, and the other members of your Committee so that by the early enactment of the Pension Portability Act we can begin moving toward the goal of increasing pension coverage, portability, and retirement savings.

Sincerely,

James M. Jeffords

Chairman PICKLE. Our first panel today will consist of the General Accounting Office and the Congressional Budget Office. Will Mr. Joseph Delfico and Rosemary T. Marcuss assume positions at the witness table. Mr. Delfico is the Associate Director of the Human Resource Division of the GAO, and Rosemary Marcuss is the Assistant Director, Tax Analysis Division of the Congressional Budget Office.

We will ask Mr. Delfico to proceed, and I have your statement here. If you would care, either one of you would care to, we will include the entire statement in our record.

Mr. DELFICO. That is fine.

Chairman PICKLE. You may proceed as you wish, Mr. Delfico.

STATEMENT OF JOSEPH F. DELFICO, SENIOR ASSOCIATE DIRECTOR, HUMAN RESOURCES DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY BERMA KLEIN, TIMOTHY CARR, AND WAYNE UPSHAW

Mr. DELFICO. Thank you, Mr. Chairman.

With me today are Ms. Berma Klein, Mr. Timothy Carr and Mr. Wayne Upshaw, who all contributed to our effort.

Mr. Chairman and members of the subcommittee, we appreciate the opportunity to testify on pension portability and preservation issues. Pension portability refers to workers being able to transfer years of service or vested assets from one employer's pension plan to another. Pension preservation refers to assuring that workers who change pension plans conserve any cashed-out assets for retirement income rather than spending them for nonretirement purposes. Several legislative proposals currently being considered address various aspects of these issues.

The primary motivation for portability and preservation proposals is the desire to promote adequate retirement income. The lack of pension portability may cause the retirement income of workers who change employers to be lower than if they had stayed with the same employer's plan for a full career, even if they are fully vested in each employer's pension plan.

In addition, research has shown when job changers have been able to cash out vested pension assets, most have used the money for nonretirement purposes. Continued use of cash-out pension assets as in the past will clearly hinder achievement of adequate retirement income.

At the request of your subcommittee, we reviewed recent studies and legislative proposals relating to pension portability and preservation for workers who are vested in pension plans. In particular, we responded to three questions that are crucial to understanding these issues. The first is how does job mobility affect workers' pension income in retirement? The second question is, what kind of portability and preservation arrangements currently exist; and the third, what problems and tradeoffs are involved in implementing proposals to enhance the portability and/or preservation of pension benefits?

Job mobility can affect workers' pension income in a number of ways. For instance, some workers do not remain with an employer long enough to meet the plan's participation in vesting require-

ments. Our testimony today relates only to how job mobility affects workers with vested pension benefits.

These effects are different from participants in defined benefit plans and defined contribution plans. An employee vested under a series of defined benefit pension plans can accumulate significantly lower pension benefits than an employee who remains under one pension plan for a full career.

Using an example developed by the Congressional Research Service to illustrate the job mobility loss, we compared the annual pension benefits of two retired employees with an identical salary history and pension plan provisions who differ only in mobility. The chart here on my right, Mr. Chairman, shows the differences in three kinds of pension plans. The straight line I will get to later is the—the red line—is the defined contribution plan, the orange line shows the pension benefits of a mobile worker, and the green line the pension benefits of a stable worker, one who stays with a plan for a 42-year history in this example.

The mobile employee's total pension benefit from the five different plans would be $9,800, or about 51 percent of the nonmobile employee's single plan pension income of $19,000, as the chart shows. In this case, the job mobility loss is about 49 percent. This loss would be smaller for a mobile worker whose pension coverage is not exclusively in defined benefit plans that use final pay formulas or workers with fewer job changes, slower salary growth or earlier retirement age.

Further, to the extent workers receive a second pension, the overall retirement income loss would be less.

Job mobility loss occurs because pension benefits under the defined benefit plans often are tied to salaries, which typically increase through the worker's career but are only taken into account as long as he or she is continuously covered under the pension plan. Thus, a loss occurs when a worker leaves a final pay plan before retirement.

In this case, pension benefits are based on a worker's final average earnings at termination rather than at retirement age when the worker's earnings are likely to be higher. Workers in a series of defined contribution plans who are vested when they leave their employees' plans will not experience a job mobility loss if their pension assets remain in place or are rolled over into an IRA or subsequent plan. This assumes the rate of return on the funds is the same no matter who manages them. The loss is avoided because the value of the pension assets, and hence retirement benefits, is based on market performance of an investment fund, not on final earnings and years of service.

Also, workers who have become vested in two or more defined contribution plans over the course of their careers may do better than mobile workers vested in two or more defined benefit plans, as we see here in the chart. According to this illustration, the employee covered under the defined contribution plan, regardless of the number of job changes, would have an annual pension benefit of $12,100 a year or about 23 percent more than the mobile employee's total pension income of $9,800 a year under a series of defined benefit plans.

Portability of service in the private pension system is limited to multiemployer plans and reciprocity agreements among single-employee plans but only a minority of pension plan participants belong to these plans. Portability of assets refers to the practice of giving workers a lump sum cash-out of their vested benefits when they leave their company's benefit plan rather than deferring benefits to retirement. It is more common than portability of service.

The issue of preservation arises in those instances in which workers receive cash-outs. Workers may preserve cashed out pension assets for retirement by transferring them to an IRA or in a few cases to another employer's plan. Such assets then can continue to grow on a tax-deferred basis. Many employees, however, have spent, rather than preserved, pension assets when changing jobs. Whether lump sums are saved or spent may affect income adequacy in retirement.

Most workers who left their employer with cashed out pension assets did not roll over the money into retirement vehicles—about 95 percent of them. Only about 30 percent used these funds for any kind of investment according to a 1986 study. There are a number of options which seek to maintain the value of pensions from the defined benefit plans, increase portability of pension assets and encourage workers to preserve their cashed out pension assets. First, portability of service and indexing vested deferred benefits are two recognized methods for maintaining the value of mobile workers pension benefits from defined benefit plans. Under portability of service, workers final employers would credit their workers years of service with previous employers in determining pension benefits.

Alternatively, employers could index workers' vested pension benefits by using an inflation index, such as the Consumers Price Index. Both of these methods would be costly to employers with portability of service, posing administrative problems as well. These methods would make defined benefit plans less effective as an instrument of personal policy. Consequently, defined benefit plans' continuation and plan formation may be discouraged.

Second, cashing out workers vested pension assets would permit them to consolidate assets from two or more plans in an IRA or in an account with a central clearing house. This could simplify workers' recordkeeping and retirement planning. Form the plan sponsors' point of view paying cash outs would save plans the trouble of making small benefit payments, also defined benefit plan sponsors would not have to pay premiums to the Pension Benefit Guarantee Corporation to insure the benefits of vested separated participants.

On the other hand, portability of assets generally would not increase workers' total pension benefits. In particular, it would not eliminate the job mobility loss because the value of cash out is calculated on the basis of a worker's final pay when they leave the plan.

Third proposals aimed at maintaining pension assets seek to encourage workers to roll over cash outs into an IRA or other vehicles to make it more likely pension assets will be used for retirement. These proposals incorporate one or more of several options. For instance, one idea involves establishing a national portability clearing house to manage workers' pension assets from previous employers.

A second would make it possible for a plan sponsor to transfer cash out directly to an IRA or other qualified retirement plan rather than having to give pension assets to separating employees.

A third would restrict workers' abilities to spend cash outs prior to retirement or increase disincentives associated with assuming cash outs. Another would allow workers to roll over previously taxed employee contributions into IRA's or successor plans.

These proposals generally do not pose the same trade offs as other proposals in terms of operation of a pension plan because they deal with the treatment of assets that have already been distributed from the pension fund. Spending pension assets before retirement may be less of a problem in the future however because of the new rules contained in the Tax Reform Act of 1986. It is too early to determine the impact of these new rules and hence the potential benefits of further restrictions are unclear.

The current legislative proposals that we have identified generally deal with options for encouraging preservation of pension benefits, they do not address portability of service. Efforts to increase pension portability aim to insure adequacy of retirement income but undermine the use of defined benefits plans as a personnel management tool.

Our assessment indicates that implementing the portability proposals currently under discussion would entail difficult economic trade offs by employees, employers, and the Federal Government.

For employers more pension portability could mean greater liabilities, additional administrative expenses and an increase in labor turn over. Employers could act in various ways. If the Federal Government did not pick up a substantial portion of the additional cost, employers may decide to shift defined contribution plans as the primary pension plan.

If this occurs, workers' retirement income will depend upon the rate of return on their pension contributions rather than on a guaranteed benefit under a defined benefit plan. Some would find this course of action objectionable because the retirement income security of workers would be less certain. Pension preservation proposals would have less of an effect on the pension system unless greater portability of assets is also required.

Increasing preservation of pension assets would constrain workers rather than plan sponsors. However, requiring defined benefit plans to cash out assets whenever a worker terminated would complicate funding and add to its administrative burdens.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you have.

[The statement of Joseph F. Delfico follows:]

STATEMENT OF JOSEPH F. DELFICO, SENIOR ASSOCIATE DIRECTOR, HUMAN RESOURCES DIVISION, GENERAL ACCOUNTING OFFICE

Mr. Chairman and members of the Subcommittee, we appreciate the opportunity to testify on pension portability and preservation issues. Pension portability refers to workers being able to transfer years of service or vested assets from one employer's pension plan to another. Pension preservation refers to assuring that workers who change pension plans conserve any cashed-out assets for retirement income rather than spending them for nonretirement purposes. Several legislative proposals currently being considered address various aspects of these issues.

Portability and preservation issues are of long-standing concern to the Congress and others. For example, the 1965 report of the President's Committee on Corporate Pension *Funds and* Private Retirement and Welfare Programs advocated, among other things, the establishment of a central clearinghouse to manage employees' cashed-out pension assets. A similar proposal was included in the Senate-passed version of the legislation that became the Employee Retirement Income Security Act of 1974 (ERISA). Other proposals have been debated, considered, and studied since the passage of ERISA. The fact that even today the discussions continue is evidence that while the issues are difficult to address, interest in them, particularly in the Congress, has not abated.

The primary motivation for portability and preservation proposals is the desire to promote adequate retirement incomes. The lack of pension portability may cause the retirement income of workers who change employers to be lower than if they had stayed with the same employer's plan for a full career even if they are fully vested in each employer's pension plan. In addition, research has shown that when job changers have been able to cash out vested pension assets, most have used the money for nonretirement purposes. To help preserve pensions for retirement income, provisions in the Tax Reform Act of 1986 were designed to provide a disincentive for using these funds for purposes other than retirement. The effectiveness of this legislation is not known yet. Continued use of cashed-out pension assets as in the past will clearly hinder the achievement of adequate retirement incomes.

At the request of your Subcommittee, we reviewed recent studies and legislative proposals relating to pension portability and preservation for workers who are vested in pension benefits. In particular, we responded to three questions that are crucial to understanding these issues. Our findings can be summarized as follows:

1. How does job mobility affect workers' pension income in retirement? Compared to those who stay in one plan, workers who vest in a series of defined benefit plans could suffer retirement income losses. Their pension benefits under each plan are frozen at the time they separate and will not reflect salary growth between the time they leave the plan and the time they retire. In contrast, workers in a series of defined contribution plans who are vested when they leave their employer's plan will not experience a job mobility loss if their pension assets remain in the plans or are rolled over into an Individual Retirement Account (IRA) or a subsequent plan.

2. What kind of portability and preservation arrangements currently exist? Portability of service and pension assets is limited, with the exception of the social security system. Employees can preserve cashed-out pension assets (apart from previously taxed employee contributions) for retirement by transferring them to IRAs or, in a few cases, another employer's plan. Such assets then can continue to grow on a tax-deferred basis. Many employees, however, have spent rather than

preserved their cashed-out pension assets when changing jobs.

3. What problems and tradeoffs are involved in implementing proposals to enhance the portability and/or preservation of pension benefits? Current legislative proposals address pension preservation primarily by building on the concept of the rollover IRA; some such proposals could increase plans' administrative burdens. Some of the options that analysts advocate for maintaining the purchasing power of mobile workers' pensions from defined benefit plans, such as indexing deferred benefits, have substantial drawbacks. They would significantly increase employers' costs and administrative burdens and remove some of the advantages these plans have for personnel management. Employers could react by switching from defined benefit to defined contribution plans, but this is a riskier way for workers to obtain adequate retirement incomes.

JOB MOBILITY MAY REDUCE WORKERS' PENSION INCOME

To become legally entitled to pension benefits (vested), workers must meet a plan's eligibility requirements and then remain in the plan a specified length of time. Because the Tax Reform Act of 1986 shortened the vesting timetables (e.g., from 10 years to 5 years), more workers are likely to have vested benefits in the future. Our testimony today and the pension portability and preservation proposals we reviewed relate only to workers with vested pension benefits.

Pension plans fall into two categories--those with defined benefits and those with defined contributions. Of all active plan participants in 1980, 60 percent (about 30 million) were in only a defined benefit plan, 26 percent (about 13 million) were in a defined benefit plan and at least one supplemental defined contribution plan, and 14 percent (about 7 million) participated only in a defined contribution plan.

Defined Benefit Plans

A defined benefit plan uses a specific formula to compute workers' pension benefits. According to 1984-87 pension data, about 69 percent of single-employer defined benefit plan participants belonged to plans that used "final-pay" formulas, which base benefits in part on salary immediately before retirement. For instance, the pension might be defined as one percent of "high-five" pay (the average of the highest 5 years of salary) times years of service. Other defined benefit plans base benefits on career average salary or pay a flat dollar amount per year of service (the latter is typically used by union plans for workers whose salaries are similar to one another).

Defined benefit plans help plan sponsors achieve various personnel management goals:

1. Because benefits accrue slowly during the early years of participation (compared with defined contribution plans), employers can offset higher training costs for newer employees with relatively low pension contributions.

2. The benefit formula encourages workers to remain with an employer during their prime productivity years.

3. The employer can use special formulas to encourage older workers to take early retirement.

4. When employers set up plans, workers can receive past service credit so that their pension benefits reflect all years of service with the employer.

From the worker's point of view, defined benefit plans provide predictable benefits that typically are tied to earnings immediately before retirement. Further, such plans put the risk of investment performance on the employer, not the employee. That is, if the investment return on pension assets is not sufficient to meet benefit liabilities, plan sponsors are required to make up the difference with increased employer contributions. Even if sponsoring companies go bankrupt without sufficient assets to meet their pension liabilities, some percentage of the employee's vested benefit is generally guaranteed by the Pension Benefit Guaranty Corporation (PBGC). On the other hand, as described below, workers with vested benefits who leave a series of defined benefit plans before retirement will usually receive less pension income than workers who stay in a plan until their retirement age.

Defined Contribution Plans

In contrast to a defined benefit plan, the pension benefit from a defined contribution plan is based on the amount accumulated in the participant's individual account, not on a predetermined formula. In many types of defined contribution plans, the employer annually makes a specific contribution to each participant's account; for instance, 10 percent of pay or a percentage of the employer's profits. Each account also is credited with its share of investment return, including any increases or decreases in the market value of the underlying assets. In some plans, participants also receive a pro rata share of contributions made on behalf of employees who separate before they are vested; these funds are known as forfeitures. The pension at retirement or termination of employment may be paid in a lump sum, a life annuity, or a series of installments until the account is exhausted.

From the employer's standpoint, defined contribution plans offer the advantages of administrative simplicity and less regulation. From the worker's point of view, compared to a defined benefit plan, the value of defined contribution plan assets builds at a faster rate during the early years of a worker's participation, but slower during later years. Second, the vesting schedules are usually shorter. Third, as described below, workers' benefits are not generally affected by changing employers. On the other hand, the employee bears the risk associated with the investment performance of the pension assets; thus, there is no guarantee of a set relationship between salaries earned immediately before retirement and the pension benefit.

Defined Benefit Plans and Job Mobility Loss

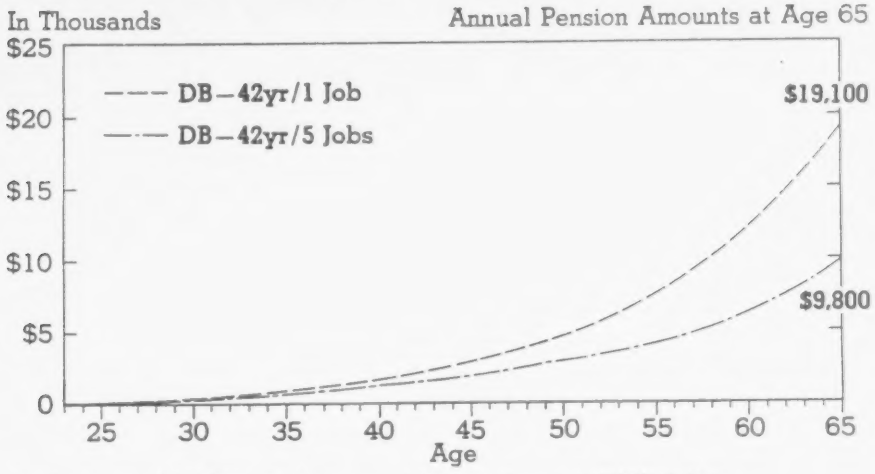
An employee vested under a series of defined benefit pension plans can accumulate significantly lower pension benefits than an employee who remains under one pension plan for a full career. This is true even if all the plans have the same benefit formulas and the employees have identical salary histories. For this discussion, we will refer to the reduction in pension benefits caused by changing employers as job mobility loss. To calculate the loss, we first take the actual benefit that the employee will receive from all employers and divide it by the pension benefit that a mobile employee would have received if the last employer calculated the pension benefit based on the employee's full career service. Then we subtract this percentage from 100 percent.

Using an example developed by the Congressional Research Service (CRS) to illustrate the job mobility loss, we compare the annual pension benefits of two retired employees with identical salary histories and pension plan provisions who differ only in job mobility (see fig. 1). Each pension plan provides a retirement benefit equal to 1 percent of high-five pay for salary up to the average social security taxable wage base, and 1.5 percent above it (a common private sector practice called integration), multiplied by years of service. All amounts shown are in 1988 dollars. Under this final-pay plan, one employee works 42 years for the same employer while the other employee works for five different employers (2 years with the first employer, 5 years with the second, 10 years with the third, 10 years with the fourth, and 15 years with the fifth).

The mobile employee's total pension benefit from the five different plans would be $9,800, or about 51 percent of the nonmobile employee's single plan pension income of $19,100. In this case, the job mobility loss is about 49 percent. This loss would be smaller for a mobile worker whose pension coverage is not exclusively in defined benefit plans that use final pay formulas or for a worker with fewer job changes, slower salary growth, or an earlier retirement age. Furthermore, to the extent that a worker receives a second pension, such as a thrift plan, the overall retirement income loss would be less.

Figure 1:

Impact of Job Mobility on Pension Amounts for Equal Cost Pension Plans



Starting pay of $20,000; Ending pay of $48,700. Constant (1988) dollars.

Source: Congressional Research Service

Components of Job Mobility Loss

Job mobility loss occurs because pension benefits under defined benefit plans often are tied to salaries, which typically increase throughout the worker's career but are only taken into account as long as he or she is continuously covered under the pension plan. Thus a loss occurs, for example, when a worker leaves a final-pay plan before retirement age. In this case,

pension benefits are based on the worker's final average earnings at separation, rather than at retirement age, when the worker's earnings are likely to be higher.

The earnings growth over a career that causes job mobility loss is attributable to two factors:

Inflation loss. Each time workers in defined benefit plans change employers, their vested pension benefits usually are retained by the employer and payment is deferred until retirement. Between the time the worker leaves a plan and benefit payments begin, the amount of the deferred benefit is frozen. Therefore, the purchasing power of the benefit is eroded by inflation. An inflation rate of 4 percent, for example, would reduce the real value of a pension benefit deferred for 15 years by about 44 percent.

Real earnings-growth loss. Presumably, workers become more efficient and effective at their jobs the longer they perform the same job tasks. In addition to wage and salary increases designed to offset inflation, employers may also compensate workers to reflect increases in their productivity that result from job tenure. Within-grade pay adjustments for federal workers are an example of productivity growth increases. Workers also receive additional wage and salary increases resulting from career promotions. Job mobility loss happens because future wage and salary gains are not recognized in calculating deferred retirement benefits.

Defined Contribution Plans and Job Mobility Loss

Workers in a series of defined contribution plans who are vested when they leave their employers' plans will not experience a job mobility loss if their pension assets remain in the plans or are rolled over into an IRA or a subsequent plan. This assumes the rate of return on the funds is the same no matter who manages them. The loss is avoided because the value of the pension assets, and hence retirement benefits, is based on the market performance of an investment fund, not on final earnings and years of service. Workers who become vested in two or more defined contribution plans over the course of their careers may do better than mobile workers vested in two or more consecutive defined benefit plans, as shown in figure 2.

This illustration, also developed by CRS, contrasts the earlier example of the two employees under defined benefit plans with an employee under a defined contribution plan of equal cost. The employee covered under the defined contribution plan, regardless of the number of job changes, would have an annual pension benefit of $12,100, or about 23 percent more than the mobile employee's total pension income of $9,800.

In summary, mobile workers vested under a series of defined benefit plans often accrue lower retirement benefits than do workers with comparable pension plans who work their full career for one employer. In contrast, the vested pension benefits of workers participating in defined contribution plans are not affected by job mobility. Even though workers in a defined benefit plan are at a disadvantage in terms of prospects for future pension income when they change employers, such plans offer employers and workers advantages not offered by defined contribution plans.

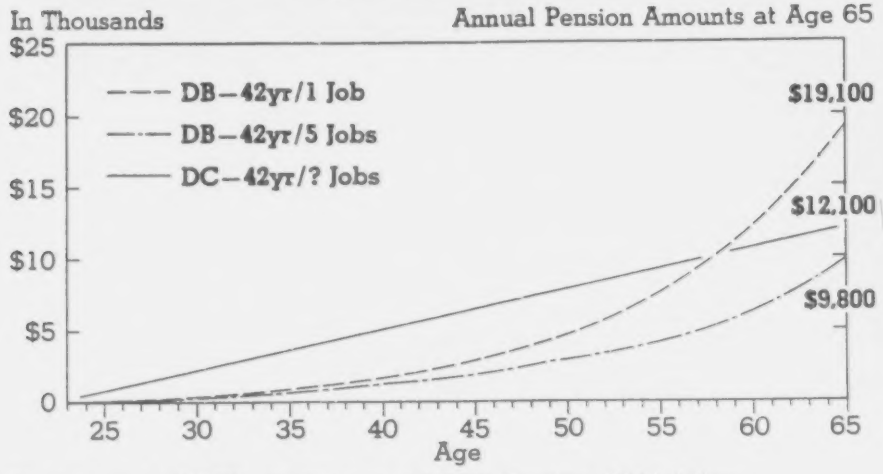
LIMITED PORTABILITY AND PRESERVATION ARRANGEMENTS EXIST

We have identified several examples of public and private pension plans that provide pension portability for mobile workers. In addition, under current law all workers who receive

cashouts are permitted to use IRAs to preserve pension benefits until retirement.

Figure 2:

Impact of Job Mobility on Pension Amounts for Equal Cost Pension Plans



Starting pay of $20,000: Ending pay of $48,700. Constant (1988) dollars.

Source: Congressional Research Service

Portability of Service

Portability of service--allowing employees to transfer years of service credit from one defined benefit plan to another--exists in the public sector, but only in limited cases in the private sector.

Social security is our nation's most portable pension system. It bases benefits on earnings over an employee's entire career, no matter how many times the worker changes employers. However, employment in positions not covered by social security results in no credit for that service. Since its inception in 1935, coverage under social security has expanded considerably, presently including almost all workers in the economy.

Examples of portability of service in the private sector include collectively bargained multiemployer plans, as well as networks of single-employer plans with portability or reciprocity agreements. In 1985, about 6.3 million individuals, or about 16 percent of all active private pension plan participants, were covered by about 3,000 multiemployer plans. The plans covering the Bell System companies provide an example of reciprocity agreements. Only about 8 percent of all single-employer pension plans have reciprocity agreements with unrelated employers, however, according to a 1981 study sponsored by the Department of Labor.

Portability of Assets

Portability of assets refers to the practice of giving workers a lump-sum cashout of their vested pension benefits when they leave a company's pension plan rather than deferring payment until retirement age. The cashout represents the present value of future benefits from defined benefit plans or the vested account balance from defined contribution plans. Under one legislative proposal, these assets would be transferred directly to a worker's IRA. Portability of assets is more common than portability of service.

Cashouts of assets generally take place at the plan sponsor's option. A cashout may occur under either a defined benefit or a defined contribution plan. An estimated 30 percent of participants in defined benefit plans and 82 percent of participants in defined contribution plans in 1984 were in plans that permitted cashouts of vested benefits under at least some circumstances, according to a 1986 study. Generally, cashouts from defined benefit plans were not large. Only about 3 percent of single-employer defined benefit plans accepted assets transferred from prior plans, according to a 1981 study for the Department of Labor.

Pension Preservation

The issue of preservation arises in those instances in which workers receive cashouts upon leaving pension plans. Currently, workers may preserve their pension assets for retirement by transferring them into IRAs or (in rare instances) other qualified pension plans, but in many cases workers spend the assets rather than roll them over.

Whether lump sums are saved or spent may affect income adequacy in retirement. Most workers who left their employer with cashed-out pension assets (about 95 percent) did not roll over the money into other retirement vehicles; only about 30 percent used the funds for any kind of investment, according to a 1986 study.

More workers may preserve pension assets in the future because of changes resulting from the Tax Reform Act of 1986. The law raised the cost of spending cashed-out pension benefits before age 59-1/2 in at least two ways: (1) it eliminated 10-year averaging for income tax purposes and (2) it imposed a 10-percent penalty tax on pension plan assets that are not rolled over into an IRA or other qualified plan. This essentially makes the treatment of lump-sum payments similar to the treatment of premature withdrawals from IRAs. Because of these changes, more workers may save their pension assets for retirement purposes.

IRAs are a currently available mechanism for mobile workers to preserve their cashed-out pension assets. Under current law, however, workers may not roll over their own previously taxed contributions into a successor plan or IRA. Also, plan sponsors may not directly transfer cashed-out pension assets to an employee's IRA or another employer-sponsored plan.

Although preservation of pension assets is an issue for both defined benefit and defined contribution plans, it is currently more of a problem with cashouts from defined contribution plans. This is because (1) in defined contribution plans pension assets build up faster during early years of plan participation when workers are most likely to change employers (see fig. 2) and (2) as we noted earlier, defined contribution plans generally cash out employees when they leave their employers. By contrast, in defined benefit plans (1) pension assets build up faster in later years of participation when workers' salaries and years of service are higher and (2) only a relatively small proportion of

defined benefit sponsors allow terminating employees to receive lump sums of more than $3,500.

PROBLEMS AND TRADEOFFS IN IMPLEMENTING PORTABILITY AND PRESERVATION PROPOSALS

We have identified a number of options that seek to (1) maintain the value of pensions from defined benefit plans, (2) increase the portability of pension assets, and (3) encourage workers to preserve their cashed-out pension assets. Their primary goal is to help ensure adequate retirement incomes. Some options have been included in bills that have been introduced in this session of the Congress, while others that we have identified are based on earlier proposals or discussions in studies, the press, or other forums. These ideas include:

1. Maintaining the Value of Benefits From Defined Benefit Plans

   -- Increasing portability of service.

   -- Indexing deferred pension benefits.

2. Increasing Portability of Assets

3. Encouraging Preservation of Pension Assets

   -- Establishing a national portability clearinghouse to manage workers' pension assets from previous employers.

   -- Making it possible for plan sponsors to transfer cashouts directly to IRAs or other qualified retirement plans, rather than having to give pension assets to separating employees.

   -- Restricting workers' ability to spend cashouts before retirement or increasing disincentives associated with consuming cashouts.

   -- Allowing workers to roll over previously taxed employee contributions into IRAs or successor plans.

   -- Requiring retirees to receive their pensions in the form of lifetime annuities rather than lump sums.

The current legislative proposals that we have identified generally deal with options for encouraging the preservation of pension benefits and, to a lesser extent, with portability of assets. They do not address portability of service.

Maintaining the Value of Benefits From Defined Benefit Plans

Portability of service and indexing vested deferred benefits are two recognized methods for maintaining the value of mobile workers' pension benefits from defined benefit plans.

Under portability of service, workers' final employers would credit their workers' years of service with previous employers in determining pension benefits. This would eliminate the entire job mobility loss because it would effectively grant to all employees the higher benefits accruing to nonmobile employees that are depicted in Figure 1. For this reason portability of service would cause a substantial increase in cost, all other things being equal.

Alternatively, employers could index vested pension benefits. By using an inflation indicator as an index, such as the Consumer Price Index, pension benefits would be protected from inflation losses. By using an average earnings index, such as the social security average wage index, pension benefits would

be protected from both inflation and productivity losses. Indexing deferred pension benefits would substantially reduce--but not eliminate--job mobility loss to the extent that workers' earnings over a career tend to increase faster than inflation and productivity gains. According to Congressional Budget Office estimates, indexing vested deferred pension benefits would increase the liabilities of a typical plan by 10 to 20 percent.

On the other hand, employers might reduce overall pension benefits to offset the increased cost. In this case benefits for nonmobile employees would have to be reduced to offset the higher benefits earned by mobile employees. Thus nonmobile employees would implicitly pay a price for portability of service or indexing of deferred vested benefits.

Some experts question whether the increased labor mobility likely to occur with greater portability of service or indexing of deferred vested benefits is good for the economy. They argue that employers need to be able to recoup investments in recruiting and training workers. Accordingly, one advantage of defined benefit plans is that they discourage turnover in the firm's work force. The loss of control over turnover could threaten the purpose of defined benefit plans as an instrument of personnel policy. Also, given the cost of portability of service or indexing and the generally heavier regulatory burden borne by defined benefit plans, defined benefit plan continuation and plan formation may be discouraged.

In addition, portability of service would pose substantial administrative problems.

-- Special cost-sharing arrangements would have to be implemented to avoid shifting the entire economic consequences of preventing job mobility loss to workers' final employers.

-- The paperwork burden on plans would be substantially increased because plan sponsors (or a central clearinghouse) would have to keep track of an employee's service under various employers and allocate costs among these employers.

-- Coordinating the benefits of plans with different formulas or different actuarial assumptions would require a method of translating the pension credits of one plan into those of another.

-- Inclusion of federal, state, and local employees in any portability or reciprocity scheme would have to be considered. State and local pension plans currently are exempt from many federal regulations.

Increasing Portability of Assets

Cashing out workers' vested pension assets would permit them to consolidate assets from two or more plans in an IRA or an account with a central clearinghouse. This could simplify workers' recordkeeping and retirement planning. It would also allow them or their estates to gain access to these assets in the event of disability, death, or other contingencies.

From the plan sponsor's point of view, paying cashouts would save plans the trouble of making small benefit payments. Also, defined benefit plan sponsors would not have to pay premiums to PBGC to insure the benefits of vested separated participants.

On the other hand, portability of assets generally would not increase workers' total pension benefits. In particular, it would not eliminate the job mobility loss in defined benefit

plans because the value of the cashout is calculated on the basis of workers' final pay when they leave the plan. That pay is generally lower than their final pay at retirement. Pension experts who have examined proposals to increase portability of assets have identified the following problems with implementing these schemes.

-- Increased portability of assets would necessitate increased liquidity in pension funds. Also, it would complicate funding of defined benefit plans, insofar as the plans' actuaries normally act on the assumption that the plan would begin to pay benefits at retirement age, not at the date of separation, which is more difficult to predict. Furthermore, defined benefit plan sponsors would incur an additional administrative burden in calculating appropriate cashout amounts.

-- If portability of assets involves rolling over assets from a defined benefit plan to the worker's IRA (the most likely scenario), there would be a shifting of investment risk from the plan to the individual. This would make the retirement income security of workers less certain.

-- Workers who were cashed out of a defined benefit plan at termination of employment would forgo any ad hoc postretirement benefit increases that might later be granted to the plan's retirees, if these increases are extended to recipients of deferred pensions.

-- Encouraging cashouts from either defined benefit or defined contribution plans might increase diversion of pension assets to nonretirement purposes. This could occur even if these assets are initially rolled over into an IRA, unless measures to encourage preservation of pension assets are also implemented.

Ensuring Preservation of Pension Assets

Proposals aimed at preserving pension assets seek to encourage or require workers to roll over cashouts into an IRA or other vehicle in order to make it more likely that pension assets will be used for retirement. As such, these proposals generally do not pose the same tradeoffs as other proposals in terms of the operation of pension plans because they deal with the treatment of assets that have already been distributed from pension funds. However, there are certain practical issues to be addressed.

-- Spending pension assets before retirement may be less of a problem in the future because of the new rules contained in the Tax Reform Act of 1986. It is too early to determine the impact of these new rules, and hence the potential benefits of further restrictions are unclear.

-- When employees have some discretion as to how much money is contributed to a plan (e.g., 401[k] plans), additional restrictions on spending of assets may discourage them from using the plan to save for retirement.

-- Some preservation proposals would establish a central clearinghouse as the repository of cashed-out pension assets. Several experts have expressed concern that the decisions concerning how to invest the assets of a federally controlled fund could become a political issue.

-- Encouraging or requiring pension assets to be rolled over into successor plans and IRAs might increase retirement savings, but it would also likely reduce the revenue to the Treasury. This is because fewer premature withdrawal penalties would be collected and the investment income on these funds would accumulate tax-deferred.

-- We were not able to identify any studies indicating to what extent retirees withdraw assets from pension and IRA accounts in lump sums, rather than purchase annuities or otherwise spread pension income over their remaining lifetimes.

CONCLUDING OBSERVATIONS

The role of the private pension system has undergone substantial changes. Initially, the pension system was used primarily as a personnel management tool, allowing employers to reward long and loyal service and move people out of the work force with attractive retirement options. Over time, the Congress has sought to use pensions more as an instrument of public policy, adding requirements that help a broader cross section of workers to gain pension income. These dual purposes--personnel management and retirement income adequacy--can cause the system to work at cross-purposes.

Efforts to increase pension portability and preservation of pension assets aim to ensure adequacy of retirement income, but undermine the use of defined benefit plans as a personnel management tool. Our assessment indicates that implementing the portability proposals currently under discussion would entail difficult economic tradeoffs by employers, employees, and the federal government.

For employers, more pension portability could mean greater liabilities, additional administrative expenses, and an increase in labor turnover. Employers could react in various ways. For example, if the federal government does not pick up a substantial portion of the additional cost, employers may decide to shift to defined contribution plans as the primary pension plan. If this occurs, workers' retirement income will depend on the rate of return on their pension contributions rather than on a guaranteed benefit under a defined benefit plan. Some would find this course of action objectionable because the retirement income security of workers will be less certain.

Pension preservation proposals would have less of an effect on the pension system, unless greater portability of assets is also required. Increasing preservation of pension assets would constrain workers rather than plan sponsors. However, requiring defined benefit plans to cash out pension assets whenever a worker terminated employment would complicate funding and add administrative burdens.

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Mr. Chairman, this concludes my statement. I would be happy to answer any questions at this time.

Chairman PICKLE. Thank you.

We will proceed with Ms. Marcuss and then we will have questions for both of you. Your entire statement will appear in the record.

STATEMENT OF ROSEMARY D. MARCUSS, ASSISTANT DIRECTOR FOR TAX ANALYSIS, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY DAVID LINDEMAN AND LARRY OZANNE, PENSION ANALYSTS

Ms. MARCUSS. Thank you, Mr. Chairman, for the opportunity to testify on pension portability. With me today are David Lindeman and Larry Ozanne, CBO's principal analysts on pension issues.

Pension portability is a subject that CBO has studied in the context of how job mobility affects the distribution of tax benefits from qualified plans, and, to this end, we have developed some measures. Because it affects both the provision of adequate income for all retired workers and the distribution of the tax advantages, pension portability is an important issue, and we welcome this timely investigation into the issue afforded by these hearings.

I have 27 pages of prepared text that I do not propose to read. I will summarize the main points to be made in response to the questions that you asked us in our invitation to testify. I request that my prepared text be inserted in the record.

Mr. ANTHONY [presiding]. Without objection.

Ms. MARCUSS. There are four major points that we would like to emphasize. First, the current pension system poses some questions of tax equity that have already been mentioned. People with the same lifetime incomes get very different gains in retirement income from the tax advantages of qualified plans, merely because of differences in tenure in jobs at different points during their work lives. The principal reason for these disparities is the structure of defined benefit pension plans, which are the mainstay of our current private employer pension system. Workers who change jobs more often and later in life generally receive less from defined benefit plans than those who work for fewer employers.

Second, restructuring defined benefit plans to increase what is called service portability—that is, the preservation of credits for past service—could provide more equitable tax benefits for mobile workers, but those changes could also have substantial and hard-to-measure effects on labor markets.

Third, changes in asset portability—roughly defined as the preservation of accrued benefits—will not fundamentally alter the pension amounts available upon retirement.

And, finally, the issues of pension portability may ameliorate over time if more employers and workers choose to shift toward defined contribution plans, at least as supplements to defined benefit plans. The written testimony discusses why pension portability is an issue, the nature and size of the effects of job mobility on future pension receipt, the effects of recent legislation on portability, and what initiatives are available for increasing portability. I will go quickly through my statement and cover only the main points.

Why is pension portability an issue? For the reasons already mentioned by Mr. Delfico: workers typically change jobs during

their lifetime; the pension system is dominated by defined benefit plans; and the current Federal income tax system gives special preferences for qualified savings in pension plans.

Most workers change jobs several times in their working lives. Among recent Social Security recipients, one-third of men and two-thirds of women had spent less than 20 years in any one job. The reasons for leaving a long-held job before retirement range from economywide events like recessions to personal events. Most job changes are voluntary, but a significant number are involuntary. There is, however, no strong evidence to date that current workers will be more or less mobile over their entire work lives than workers in earlier generations. For example, in the last 5 years, the median job tenure has been relatively stable—4.4 years median tenure in 1983, 4.2 years in 1987.

Within our voluntary pension system, employers and unions design pensions that they perceive as meeting their long-term economic interests. The dominant type of pension they choose is the defined benefit plan. As Mr. Delfico has pointed out, the issues of pension portability are most acute among defined benefit plans. Promised benefits in these plans are usually based on years of service and current dollar salary at the time the worker leaves the plan. For a worker who leaves a plan long before retirement—say age 40—the salary base that defines his or her benefit at retirement will have eroded in purchasing power by the time that worker is eligible to draw his or her pension from the plan, typically 25 years later at age 65.

In defined contribution plans, job mobility generally does not affect the value of an individual's retirement benefits from any particular defined contribution plan. These plans are, however, the basic plans for only 30 percent of workers covered by a pension plan. About half of the labor force is covered by a pension plan at any given time.

The current Federal tax system allows pension participants to earn a before-tax rate of return to their retirement savings within tax qualified plans. Because pensions received preferred tax treatment, access to, and benefit from, pensions is therefore an especially important issue for public concern. Individuals with essentially equivalent lifetime incomes have divergent gains from tax-qualified pension plans. The major determinant of that difference is job tenure.

Next, I will provide a few measures of the effects of major mobility on future pension receipt. Job mobility and existing defined benefit pension practices affect what people receive from pensions in two key ways. First, depending on how many times the worker changed jobs, individuals with similar lifetime incomes can have different pension amounts at retirement and therefore can have different gains in retirement from the tax advantages associated with pensions. Other things being equal, the more job changes, the lower the retirement income and associated tax advantages.

Second, even among people with the same number of jobs over their lifetimes, their pensions and the associated tax advantages differ according to the length of time in a person's last job. Other things being equal, the longer an individual's tenure in the last job, the higher the retirement income and associated tax advantages.

Table 1 on page 8 of my testimony illustrates the effects of job mobility on lifetime benefits.

Chairman PICKLE. What page is that?

Ms. MARCUSS. Page 8. For the table, we have used one illustrative plan common to all five workers and five workers with the same income histories, except for the number and timing of their job changes.

I will point out just a couple of comparisons. Employees A and B have one job change, and employees C and D hold two jobs. The higher annual pension income for workers A and B points up that the individuals who change jobs less frequently have higher pensions. Because of their fewer job changes, A and B have more of their years credited toward higher salaries than do D and E.

If you also compare workers A and B, you will see that, though they have the same income histories, worker A spends 28 years in his second and last job, while B spends 15 years in the second and last job. Worker A has a significantly higher retirement income, thus illustrating that the length of time spent in a person's last job is also very important.

Some other measures of the overall effects of current pension practices as well as the effects of incomplete pension coverage, are shown on tables 2 and 3 on pages 11 and 12. These tables are projections of the retirement income for a sample of workers who are now in their late thirties and early forties at the point at which they will be retired, in the year 2019. I will focus primarily on table 2, which shows the projections for married couples at the time of retirement.

These projections suggest that pension benefits will be significantly larger for workers with long tenure in one plan. For most workers, regardless of income level, the pension benefits projected for those with long-job tenure are two to four times larger than those with relatively short tenure. Long tenure is defined as 20 or more years in one plan, and short tenure is defined as less than 20 years in any particular plan. If you look at column 2 labeled, "Distribution of Plan by Tenure," you will note that as you move up the income distribution, workers have longer tenures on average. For the bottom one-quarter of workers, 70 percent are short-tenure workers and 30 percent are long-tenure workers. That pattern is more than reversed for workers at the top end. Although the overall distribution between long- and short-tenure workers is close to 50/50, higher income workers are much more likely to have longer job tenure. Because long tenure is more characteristic of work experience of upper income workers, these workers gain more on average from pensions than do lower-income workers.

The column on the far right shows the tax advantages from qualified plans, in particular the ratio between the tax advantages for short-tenure workers—less than 20 years—to long-tenure workers—more than 20 years. Because the tax advantages track the benefits, they also show roughly the same pattern, including the greater gains for upper income workers.

I will not summarize my prepared testimony on the effects of recent legislation. I would like, however, to make one point about recent legislation. Until inflation became a persistent factor in the economy the effects of job changing on the real value of defined

benefit accruals was less evident and therefore were seen as less important for legislative action than other factors such as vesting. In recent years, however, the issue of inflation's effect on pension accruals has become much more of a policy concern. I will now quickly summarize options that are available to deal with this issue and otherwise increase pension portability.

Initiatives for pension portability can be broken down into two types. First, there are initiatives that would impose service portability, or its functional equivalent, on defined benefit plans. Second, there are those that would increase asset portability. Service portability is the ability to have work performed for different employees credited to one or more pension plans so that the lifetime value of pension benefits is not affected by job changes. In general, defined contribution plans already have the functional equivalent of service portability except for their vesting requirements. In defined benefit plans, however, the absence of service portability not only affects vesting, it also affects the value of accrued benefits. Under current requirements and practices, service portability in defined benefit plans only occurs within a minority of plans.

In theory all sponsors of defined benefit plans could be required to recognize the worker's service from previous employers. However, it is doubtful that employers would continue to sponsor single employee benefit plans in the environment of uniformity in funding and plan rules that such a requirement would necessitate.

Another option would be to require the indexation of deferred benefits for separate employees. However, the cost of this option could be significant. CBO estimates that the cost of the option could be as high as 3 percent of lifetime compensation or a comparable reduction in pension benefits paid to older, long-service workers. Alternatively, defined benefit plans could be required to have a defined contribution component in what is commonly called a floor offset arrangement. This option would have similar cost effects.

Another approach would be to specify the nondiscrimination rules so that they are cast in present value of accrued benefits rather than in terms of projected nominal benefits. A more modest requirement would be to have all employers offer a voluntary salary reduction arrangement subject to the usual nondiscrimination rules or elective deferrals.

The last set of options that I will summarize address asset portability. Asset portability is the ability of an individual to move the value of accrued benefits from one tax-advantaged vehicle to another. Although asset portability can help maintain the tax-free status of accrued benefits, it does not affect the value of the individual's accrued benefit from any particular plan at the time of separation.

One way to address asset portability would be to increase lump sum distributions to mobile workers—that is, require plans to offer a cashout option. This would allow mobile workers to combine several small pension accumulations into one larger rollover IRA that then could be converted into a single annuity at retirement. Among other disadvantages, however, expanding cashout options could lead to liquidity problems for some plans and to more preretirement consumption by workers of pension accumulations.

Another approach would be to encourage pension preservation for retirement. The ability to preserve the tax-free status of distributions from tax-qualified pensions has existed since 1975, when rollover IRA's first became effective. They have not been used much. This may change, however, in the wake of the Tax Reform Act of 1986. It is too soon to tell.

Additional restrictions could be placed on preretirement use of accrued pension rights. For example, tax-qualified pensions could be required to place any preretirement distribution into a rollover IRA, or pensions could be prevented from cashing out workers whose accrued benefits exceed a certain dollar level.

In summary: first, restructuring defined benefit plans to increase service portability or its equivalent could provide more equitable treatment for mobile workers. Such restructuring would have a substantial and hard-to-measure effect on labor markets because the incentives that employers now have to sponsor defined benefit plans—which are the mainstay of the current system—would be eroded.

Second, changes in asset portability would not alter pension amounts available at retirement.

Finally, although the issue of pension portability will continue to pose public policy questions, it may begin to resolve itself over time if more workers and employers take advantage of possibilities that already exist in the system to begin to voluntarily shift toward defined distribution plans, at least in the form of supplementary retirement savings. We have seen some evidence in the 1980's of increased usage of defined contribution plans.

I would be happy to answer any questions.

[The statement of Ms. Marcuss follows:]

Statement of
Rosemary D. Marcuss
Assistant Director for Tax Analysis
Congressional Budget Office

Thank you, Mr. Chairman, for this opportunity to testify on the topic of pension portability. Pensions not only affect the level of income people receive in their old age, but, in an economy with considerable job mobility, they also raise questions of fairness--both in how benefits are distributed relative to their costs and in how the tax advantages of pensions are distributed. Pensions also are an important element in how many businesses manage their affairs and have been the explicit subject of collective bargaining. Any new federal mandates to make pensions more portable must be carefully weighed against possible effects on established business practices, the collective-bargaining process, and the willingness of employers to sponsor plans.

My testimony today first reviews the conditions that cause pension portability to be a matter of continuing policy debate. This review will be followed by some examples of how job mobility can affect the size of a person's pension in retirement, and by some projections for today's workers of their pension benefits and the associated tax advantages. After reviewing past legislation dealing with pension portability, I will outline and analyze proposals for additional changes that would increase benefits for mobile workers, or make it easier for such workers to consolidate their benefits from several pensions and preserve them for retirement.

WHY PENSION PORTABILITY IS AN ISSUE

Several conditions combine to make portability among pensions a potential public policy concern. Those conditions are:

- Workers typically change jobs several times over their lifetimes, some more than others;
- The pension system is not uniform among employers and is dominated by defined benefit plans; and
- The current federal tax system gives participants in tax-qualified pension plans a better return on their retirement savings than others can achieve outside such plans.

Labor Force Mobility

Most workers change jobs over their working lives. Younger workers especially shift among jobs until they find a "good fit" and then settle in for long work spells. The probability of staying on the current job for another 10 years rises until workers are in their 40s. Men tend to settle in sooner than women and have longer job tenures. Men and women typically hold three to four full-time, year-round jobs over their working lives.

Although workers tend to settle into jobs by the middle of their work career, a significant number still change jobs during that time and, as a result, sacrifice the advantages, such as pension benefits, that often accompany long tenure. Professor Robert Hall of Stanford University has estimated that 20 percent of workers in their early 40s, who had already been on their job for 15 to 20 years, would leave that job within the next 10 years. Other workers fail to build up long tenures in any one job. Among recent applicants for Social Security benefits, one-third of the men and two-thirds of the women had spent less than 20 years on any one job.

Reasons for leaving a long-held job before retirement range from economywide trends to personal events. The severe recession in 1981 and 1982 and the recent competition from imports cost the jobs of many experienced workers in manufacturing. Even when the overall economy is doing well, specific firms fall on hard times and lay off workers. Workers also change jobs for solely personal reasons, such as disputes with supervisors, health problems, or, increasingly, the transfer of a spouse.

With the entrance of the baby-boom generation into the labor market and the growing participation of women in the labor force, job changing

may appear to occur even more frequently now than it did in earlier years. There is, however, no evidence to date that current workers will be more or less mobile over their entire working lives than were workers in earlier generations. In the last 5 years, the median job tenure has been stable--4.4 years in 1983 and 4.2 years in 1987.

Diversity in Pensions and the Importance of Defined Benefit Plans

Though pensions are heavily regulated, the basic decisions of whether to have a pension, of what type, and at what level are left to employers and, to a much lesser extent, workers. Under current conditions, employers and unions design pensions that they perceive as meeting their long-term economic interests. These objectives may or may not always conform with the interests of individual workers who, for one reason or another, move from job to job.

The existing pension system contains two basic models--the defined benefit plan and the defined contribution plan. The issues of pension portability are most acute for defined benefit plans. The defined benefit plan is the dominant type of pension. According to 1985 Department of Labor figures, roughly 70 percent of covered workers have a defined benefit plan as their basic pension. In defined benefit plans, the employer promises certain retirement benefits to the firm's workers, usually based on their years of service and their current dollar salary at the time they leave the plan. The salary base of a worker who leaves a plan at retirement will coincide, at least initially, with the worker's cost-of-living in retirement. For a worker who leaves a plan long before retirement--for example, at age 40--that salary base will have eroded in purchasing power by the time the worker is eligible to draw his or her pension from the plan, typically at age 65. Thus, for participants of defined benefit plans, job changing not only affects whether a worker satisfies participation and vesting requirements, but it also profoundly limits the value of a worker's benefits available at retirement.

In contrast, in defined contribution plans, the employer makes a contribution to each participant's account, usually as a percentage of salary. The pension income of people covered over their lifetimes only by defined contribution plans--for example, university personnel in the TIAA-CREF system--derives from those contributions and their investment earnings. Accordingly, except for participation and vesting requirements, job mobility generally does not affect the value of an individual's retirement benefits from any particular defined contribution plan. In 1985, such plans constituted the major pension for about 30 percent of covered workers. This percentage reflects considerable growth in the 1980s in the number of workers who are covered by defined contribution plans as their basic pension. In addition, about 40 percent of covered workers have some kind of defined contribution plan--for example, profit-sharing plans and salary reduction arrangements--as a supplement or complement to a base pension, almost always a defined benefit plan.

Most issues associated with pension portability would disappear in a universal and uniform pension system that covered all employers and was designed to accommodate job mobility--for example, a mandatory defined contribution tier such as that recommended by the 1980 President's Pension Commission, or a system of defined benefit plans organized around occupations such as exists in France. In all but name, such a system would be tantamount to an additional Social Security tier. It also could have far-reaching repercussions for labor markets, similar to ones discussed later in regard to options for the current system.

Differing Tax Treatment of Retirement Savings

Because pensions receive preferred treatment under the federal income tax, access to pensions is an especially important issue of public concern. The current federal income tax allows pension participants to earn a before-tax rate of return on their retirement savings within a

tax-qualified plan. In addition, these savings are taxed at lower tax rates in the retirement years, although this will become a less important factor in the wake of tax reform. Under current conditions, individuals with essentially equivalent lifetime incomes have divergent access to, and benefits from, tax-qualified pensions. The availability of Individual Retirement Accounts (IRAs) only partially mitigates this problem.

If all retirement savings were given the tax treatment now allowed only qualified plans and IRAs, or, alternatively, if normal income tax rules were applied to pensions--for example, by taxing pension trusts on their investment earnings--the tax equity dimension of pension portability essentially would disappear.

EFFECTS OF JOB MOBILITY ON PENSIONS AND FUTURE PENSION RECEIPT

Job mobility and existing defined benefit pension practices affect what people receive from pensions in two key ways. First, depending on how many times they change jobs, individuals with similar lifetime incomes can have different pension amounts at retirement, and, therefore, can have different gains in retirement incomes from the tax advantages associated with pensions. Second, even among people with the same number of jobs over their lifetimes, their pensions and the associated tax advantages differ according to the length of time in a person's last job. The first section below illustrates these points with examples of particular individuals; the following section presents a simulation of future pension receipt that demonstrates these results for a whole cohort of today's workers.

Examples of the Effects of Job Mobility on Lifetime Pension Benefits

In developing the examples shown in Table 1, we have used an illustrative salary projection and a typical defined benefit pension plan that the Congressional Research Service prepared for this hearing. The salary projection is for workers now entering the labor force and incorporates three factors: inflation at 4.0 percent, general productivity increases at 1.4 percent, and personal merit increases. Accordingly, the workers' salaries rise from $20,000 in 1988 to $252,873 in 2031. Inflation is the major reason for this greater-than-tenfold increase.

The pension plan formula provides a worker with an annual benefit equal to the average of the worker's final five years in the pension plan multiplied, for each year covered by the plan, by 1 percent for wages below the Social Security wage base and 1.5 percent for wages above that wage base. Benefits are reduced to reflect the cost of a joint-and-survivor annuity. Though each employer is assumed to sponsor a defined benefit plan that uses this same formula, tenure under one plan cannot be credited toward benefits in another plan. Thus, an individual starts again in each plan every time he or she moves to a new job.

As a general rule, the more times an individual changes jobs among defined benefit plans, the lower the total pension amount will be at retirement. This can be seen by comparing individuals A and B, workers who hold two jobs during their careers, to individuals D and E, who hold three jobs. The fewer job changes by A and B mean that they have more of their years credited toward higher salaries than do individuals D and E. Consequently, they have higher total pensions.

The length of time spent in a person's last job is also important. Though workers A and B each hold two jobs, the first 15 years of worker A's total pension benefits are weighted according to her salary average of roughly $45,000 when she leaves her first job at age 37, and the last 28 years are weighted according to her salary average of roughly $226,000 when she retires at age 65. Worker B is in the opposite situation: the first 28 years are weighted according to an average salary of roughly $95,000 at age 51, and the last 15 years are weighted according to the $226,000 salary average at retirement. Because of the

TABLE 1. ILLUSTRATIVE EFFECTS OF JOB MOBILITY ON LIFETIME BENEFITS FROM DEFINED BENEFIT PLANS
(Salary and pension amounts in current dollars)

Individual	Final Salary Average in Job a/			Years in Pension			Annual Pension Amount from Job b/			Total Annual Pension
	One	Two	Three	One	Two	Three	One	Two	Three	
A	44,802	226,114	—	15	28	—	6,049	64,482	—	70,531
B	95,329	226,114	—	28	15	—	24,025	34,544	—	58,569
C	c/	c/	226,114	c/	c/	25	c/	c/	59,877	59,877
D	22,343	89,995	226,114	4	23	16	d/	18,630	36,847	55,478
E	26,661	89,995	226,114	7	20	16	1,680	16,200	36,847	54,727

Source: Examples prepared by the Congressional Budget Office using salary history and pension plan developed by the Congressional Research Service.

a. Salary histories assume that earnings increase over time for three reasons: inflation (4 percent each year), general productivity increases (1.4 percent each year), and personal merit increases.

b. The pension formula provides an annual benefit equal to the average of the worker's final five years in the pension plan multiplied, for each year covered by the plan, by 1 percent for wages below the Social Security wage base and 1.5 percent for wages above that wage base. Benefits are reduced to reflect the cost of a joint-and-survivor annuity.

c. Individual C is not covered by a pension in first or second job.

d. Individual D does not vest in pension in first job.

additional 13 years that individual A spends in her last job, she receives roughly $12,000 more in annual pension benefits.

Under some circumstances, the length of time in a person's last job can be more important than the number of job changes or even coverage by a pension during the early portion of a person's working life. Though individual C holds three jobs and is not covered by a pension plan until age 40, his continuous coverage in one plan thereafter places him in a better position than anyone except individual A. Similarly, though worker D does not vest in his first pension, he loses little because his salary is relatively low when he leaves his first job. Thus, his total pension is very close to worker C's.

Simulation of Future Pension Receipt

The overall effects of current pension practices, as well as the effects of incomplete pension coverage, are illustrated in Table 2 for married couples and Table 3 for single individuals. The tables report the results of a simulation of projected pension benefits for a sample of about 7,000 people, now aged 34 to 43, in the year 2019 when they will be between the ages of 65 and 74. The simulation is discussed more fully in the Congressional Budget Office study, Tax Policy for Pensions and Other Retirement Saving (April 1987), and supporting material. The simulation generally assumes that recent and future patterns of labor mobility and pension practices will not be very different from the historical patterns that have prevailed since the 1950s. Although the simulation does not reflect recent legislation, for reasons discussed later, we believe that its basic results still hold.

These projections suggest that pension benefits will be significantly larger for workers with long tenure in one plan--illustrated here as those who stay in one pension plan for 20 years or more--compared with the benefits for those with relatively short tenure (less than 20 years in any one pension plan). For most workers the pension benefits projected for those with long plan tenure are two to four times larger than those with relatively short plan tenure.

Because the tax advantages of pensions closely track the benefits, a similar pattern exists for the tax advantages. These advantages are the gains in retirement income that the simulation projects for workers because they can receive a before-tax, rather than an after-tax, rate of return on retirement savings within their pensions. For most workers, the projections indicate that the tax advantages are three to six times larger for those with long plan tenure than for those with shorter tenure.

Among retired single individuals in the bottom half of the income distribution, however, these differences are more pronounced. Most of these individuals are projected to have long periods during which they are not covered by a pension, which lowers the size of the average pension for those with short tenure and makes the tax advantages associated with their pensions very small.

The simulations also indicate that plan tenure is strongly correlated with income: people with higher income are more likely to stay in one plan for least 20 years. Long plan tenure also is correlated with marital status at retirement: about half of all retired couples have long plan tenure, but only about one in four singles obtain 20 years or more in one plan.

The differences between workers with long plan tenure and other workers raise two equity issues--how the overall costs of pensions to workers are distributed relative to benefits, and how the tax advantages of pensions are distributed. In the view of some analysts, workers who have been covered at one time or another by a particular defined benefit plan have borne that plan's costs through proportional wage reductions, while only a relatively few--long-tenured workers who stay until retirement--receive most of the benefits. Hence, it is sometimes said that short-stayers "subsidize" long-stayers in defined benefit plans.

TABLE 2. SIMULATED RETIREMENT INCOMES, PENSION BENEFITS, AND TAX ADVANTAGES FOR RETIRED COUPLES IN 2019 (Projection for workers ages 34 to 43 in 1988)

Income Quartile	Years in One Plan	Distribution of Retirees by Plan Tenure (In percent)	Projected Retirement Income (In 1988 dollars)	Pension Benefits		Tax Advantages	
				In 1988 dollars	Ratio by Plan Tenure [a]	In 1988 dollars	Ratio by Plan Tenure [b]
Lowest	Less than 20	69	18,038	2,250		738	
	20 or more	31	22,552	8,785	3.9	3,672	5.0
Second	Less than 20	53	27,862	4,020		1,276	
	20 or more	47	32,358	12,935	3.2	5,022	3.9
Third	Less than 20	43	37,362	8,210		2,726	
	20 or more	57	42,486	19,535	2.4	7,709	2.8
Highest	Less than 20	33	53,253	11,412		3,864	
	20 or more	67	65,150	33,792	3.0	12,482	3.2
All Quartiles	Less than 20	49	30,737	5,546		1,830	
	20 or more	51	44,628	21,122	3.8	8,066	4.4

SOURCE: Congressional Budget Office.

a. Ratio of the pension benefits for workers with long tenure (20 years or more) under one pension plan to the benefits for those with shorter plan tenure (less than 20 years).

b. Ratio of the tax advantages associated with pension benefits for workers with long plan tenure to the tax advantages for those with shorter plan tenure.

TABLE 3. SIMULATED RETIREMENT INCOMES, PENSION BENEFITS, AND TAX ADVANTAGES FOR RETIRED SINGLE PEOPLE IN 2019 (Projection for workers ages 34 to 43 in 1988)

Income Quartile	Years in One Plan	Distribution of Retirees by Plan Tenure (In percent)	Projected Retirement Income (In 1988 dollars)	Pension Benefits		Tax Advantages	
				In 1988 dollars	Ratio by Plan Tenure a/	In 1988 dollars	Ratio by Plan Tenure b/
Lowest	Less than 20	96	5,211	478		51	
	20 or more	4	8,092	3,886	8.1	1,471	28.8
Second	Less than 20	80	9,584	1,178		59	
	20 or more	20	11,618	5,168	4.4	1,628	27.6
Third	Less than 20	70	15,058	2,484		522	
	20 or more	30	18,187	8,888	3.6	3,061	5.9
Highest	Less than 20	47	27,251	6,077		1,758	
	20 or more	53	36,732	21,246	3.5	7,479	4.3
All Quartiles	Less than 20	73	12,346	2,040		487	
	20 or more	27	25,734	14,103	6.9	4,920	10.1

SOURCE: Congressional Budget Office.

a. Ratio of the pension benefits for those with long tenure (20 years or more) under one pension plan to the benefits for those with shorter plan tenure (less than 20 years).

b. Ratio of the tax advantages associated with pension benefits for those with long plan tenure to the tax advantages for those with shorter plan tenure.

Another view of how workers bear the costs of pensions, however, holds that defined benefit plans elicit greater productivity from workers, and, because those productivity gains are greatest from workers who stay with the sponsoring firm the longest, these workers properly receive most of the pension benefits.

The tax equity issue is clearer. At all income levels, workers who stay with one plan for a long time, especially late in life, receive a greater amount of their retirement income from the tax advantages associated with pensions than do others with equivalent lifetime incomes. In addition, since long plan tenure is associated with higher-income workers, some upward skew in the tax advantages also exists. Nonetheless, all retirees--regardless of their plan tenure or income level--bear the costs of these tax advantages over their working lives through, for example, higher tax rates. The fact that tax advantages for pensions constitute the largest exception to normal income tax rules (measured by cash-flow revenue losses) raises questions about whether the tax preference is achieving its goal of increasing retirement income for all citizens in an equitable and efficient manner.

EFFECTS OF RECENT LEGISLATION

Legislation regulating pensions dates back to the late 1930s. The Employee Retirement Income Security Act (ERISA) of 1974 is the most significant piece of recent legislation and has been subsequently amended in major ways, especially in the 1980s. To understand why large disparities in benefit accruals are likely to continue, it is useful to review the key legal factors that determine pension receipt--eligibility rules and nondiscrimination rules--and to analyze them in light of inflation.

Eligibility Rules

In the 1980s the Congress, especially in the 1986 Tax Reform Act, further tightened ERISA's minimum rules for participation, vesting, and breaks in service, and it also limited the ability of an employer to exclude certain groups of workers from a plan's coverage. Although these recent changes will cause more people to become eligible for a pension, these new pension benefits probably will be relatively small in dollar amounts for the reasons illustrated by Table 1. Accordingly, the basic patterns in Tables 2 and 3 will not be altered very much. Most analyses indicate that the recent reduction in vesting from ten years to five years will add relatively little to aggregate retirement income. Further restrictions in vesting are likely to yield a similar result. A forthcoming study by Hay/Huggins Company for the Department of Labor shows very modest gains in additional retirement income if the law were changed to require full and immediate vesting.

Nondiscrimination Rules

Since the 1940s, the tax code has limited the extent to which plans may make distinctions among workers in benefits and contributions. Legislation in the 1980s tightened those limits in various ways, especially in the extent to which pensions can take Social Security benefits into account in their formulas. But, with the exception of determining whether a plan gives too large a share of benefits to top management (the "top-heavy" rules), these rules operate in terms of projected nominal benefits rather than the present value of accrued benefits, which takes into account the time value of money and the effects of inflation. These rules have therefore had relatively slight effects on the real lifetime benefits of workers who change jobs frequently.

Until inflation became a persistent factor in the economy, the effects of job changing on the real value of defined benefit accruals were less evident and were less important than other factors, such as vesting. As a consequence, the Congress only recently has focused on

this phenomenon, and then only in the context of a closely related matter: how a plan's termination affects the real value of workers' expected pensions. However, unlike a plan termination where individuals involuntarily experience an erosion of the value of their expected pension benefits, a person who voluntarily changes jobs presumably weighs the loss of a larger pension from his or her old job against the gain in compensation and opportunity in the new job. A different focus, suggested by these hearings, is on the many intermediate situations--such as layoffs in a declining industry, people relocating for family reasons, the effects of divorce on pension rights, and so on--that fall between an involuntary plan termination and a fully voluntary job change.

OPTIONS FOR INCREASING PENSION PORTABILITY

Policies that might address pension portability generally fall into two categories--those that would impose "service portability," or its functional equivalent, on defined benefit plans, and those that would increase "asset portability."

Service Portability

Service portability is the ability to have work performed for different employers credited to one or more pension plans so that the lifetime value of pension benefits is not affected by job changes. Service portability can occur either because service under several employers is pooled in one plan, as in Social Security, or because a successor plan credits service that a worker performed under a previous plan.

Except for participation and vesting requirements, service portability is not important for defined contribution plans. Because job changes do not affect the value of accrued benefits in defined contribution plans, these plans already have the functional equivalent of service portability.

In defined benefit plans, however, the absence of service portability affects both eligibility and the value of accrued benefits. Under current requirements and practice, service portability in defined benefit plans occurs only within the narrow framework of collectively bargained, multiemployer plans and a few single-employer plans with reciprocity arrangements. Multiemployer plans cover about 16 percent of covered workers. Only about 8 percent of all single-employer plans have reciprocity arrangements. Some limited reciprocity also exists between multiemployer plans.

In theory, all sponsors of defined benefit plans could be required to recognize a worker's service from a previous employer's plan. Such a requirement could work only if all defined benefit plans had very similar rules and pooled their liabilities. In effect, a full system of rules like those that now apply to multiemployer plans would have to be developed economywide. It is doubtful that businesses and other employers would continue to sponsor single-employer defined benefit plans in such an environment of uniformity.

Other alternatives that would impose the functional equivalent of service portability on defined benefit plans are less sweeping.

- Defined benefit plans could be required to adjust the benefits they owe to separated participants for whatever inflation occurs between the time a worker separates from the plan and the plan's retirement age. As a result, all the pensions paid to an individual from the defined benefit plans in which he or she was a participant, rather than just the pension from the last plan, would reflect the individual's cost-of-living at the time of retirement.

- Defined benefit plans could be required to have a defined contribution component in what is commonly called a "floor offset" arrangement. In these arrangements, a worker receives

the higher of the annuity promised by the defined benefit plan or the annuity financed by his or her defined contribution account. Workers with long tenure still receive advantages from the defined benefit plan, but those with shorter service receive more from the defined contribution annuities.

- The nondiscrimination rules could be modified so that plans are tested generally, as well as for top-heavy status, on the basis of present value rather than on the basis of projected nominal benefits. Each plan would have to decide how it would satisfy this more stringent nondiscrimination test.

- A more modest requirement would be to have all employers, including sponsors of defined benefit plans, offer a voluntary salary reduction arrangement to their employees, subject to the usual nondiscrimination tests for elective deferrals. This approach would allow workers who are otherwise not covered by a qualified plan, or who do not expect to stay very long under a defined benefit plan, to save more on their own initiative in a type of defined contribution plan.

To different degrees and with different effects on costs, these alternatives would increase portability in pensions and achieve greater tax equity. For example, the forthcoming Hay/Huggins study mentioned earlier concludes that most of the losses currently associated with job changing by participants in defined benefit plans would be eliminated if plans were required to inflate benefits for separated workers between separation and retirement. If such a requirement were imposed on plans, either plan costs would have to increase with commensurate reductions in current pay, or the benefits paid to workers with longer service would have to be adjusted downward to hold aggregate plan costs constant. CBO's calculations indicate that, if the effects were solely in the form of reduced current compensation, the affected workers would have roughly 0.4 percent to 2.8 percent of their lifetime compensation permanently shifted from current wages to pension benefits. The exact amount shifted would vary with the level of job turnover in the worker's defined benefit plan.

In principle, either response--reduced current wages or reduced benefits for long-tenured workers--would mean that pension benefits would be more evenly distributed and less dependent on tenure in any particular job. But these same changes could undermine the motivations for employers to sponsor defined benefit plans--namely, to bind workers to the long-term interests of the firm and to reduce turnover. Absent this so-called "lock-in" effect, it is possible that few employers would continue to sponsor defined benefit plans, especially in view of their increasing complexity and financial risks.

Some analysts have suggested recently that defined benefit plans hurt the economy precisely because, in a time of increasing global competition, they impede labor mobility. They argue that defined benefit plans should therefore be discouraged or modified to reduce their lock-in effects. On the other hand, a number of studies have argued that defined benefit plans can increase a firm's production and lead to a greater coincidence of interests among employers and workers.

The inconclusive nature of this debate suggests that the future of defined benefit plans should be left to the usual give-and-take of the labor market, especially the collective-bargaining process. After all, the pension system has always had an alternative--defined contribution plans--in which an individual's accruals, once vested, are not affected by job mobility. TIAA-CREF and similar arrangements in the education and nonprofit sectors demonstrate that where both employers and participants want retirement benefits to be relatively unaffected by job changing, a defined contribution pension system can be designed and can operate successfully over a very long time period.

Nonetheless, the defined benefit plan remains the basic form of pension for most workers, which suggests that such plans are continuing to meet what employers and workers perceive to be their needs. Of

course, defined contribution plans carry greater investment risks for the participants. But defined benefit plans also carry their own kind of risks--for example, the effects of a plan termination on the value of benefits. As employers and workers weigh these competing risks, as well as the other advantages and disadvantages associated with each pension type, preferences may shift toward defined contribution plans, as seems to have been happening in recent years. Alternatively, employers and their workers could voluntarily negotiate changes in defined benefit plans, such as the indexing option mentioned earlier, that would increase benefits for workers with shorter tenure. Nothing in current law prevents such innovations if both parties want them.

The recent revision of the pension system for federal government workers illustrates yet another alternative that is becoming increasingly widespread--namely, the complementary use of defined benefit and defined contribution plans to build a pension portfolio. The defined benefit plan in the new system remains attractive for long-service employees, while Social Security coverage and the new thrift plan--a type of defined contribution plan--are more helpful to short-service federal employees than was the old system. As a result of the new pension system, the federal work force should experience some greater job turnover in the future, but not as much as if the system had shifted entirely to Social Security and a single defined contribution plan. If, after experience with the new system, the federal government determines that it wants more or less mobility among its own workers, the relative weight given the thrift plan and the defined benefit plan could be altered. Similarly, as federal employees become increasingly familiar with a mixed system, they may begin to express a preference for a changed balance between the two plans. Indeed, the balance could be different in different agencies: what makes good pension policy for the Social Security Administration, which needs a large and stable work force across the country, may not make sense for the National Institutes of Health and its need for constant exchanges with a particular research community.

Asset Portability

Asset portability is the ability of an individual to move the value of accrued benefits from one tax-advantaged vehicle to another. Although asset portability can help maintain the tax-free status of accrued benefits, it does not affect the value of an individual's accrued benefit from any particular plan at the time of separation. In defined contribution plans, an individual's accrued benefit at separation from the plan is the amount in his or her account balance. Such amounts typically are paid out as lump sums, although some defined contribution plans offer, even require, annuity payouts instead. In defined benefit plans, an individual's accrued benefit at separation is the annuity to which the individual is entitled at the plan's retirement age. These deferred annuities can be converted to lump sums that have equivalent present values.

Two changes are commonly suggested to enhance asset portability--increasing the availability of lump-sum distributions to mobile workers, and further encouraging the preservation of those distributions until retirement.

Increase the Lump-Sum Distributions to Mobile Workers. Within certain statutory guidelines, each plan decides whether to allow separating workers the option of "cashing-out"--that is, taking their accrued benefits with them as a lump sum. Requiring plans to offer a cash-out option would allow workers more easily to combine several small pension accumulations into larger rollover IRAs that eventually could be converted into a single annuity at retirement. Such a change in the law also might better assure that workers collect the full amount of their pensions. Plans lose touch with separated workers, and those workers sometimes fail to apply for their deferred annuities at retirement. On the other hand, expanding cash-out options for workers could lead to liquidity problems for some plans and to more preretirement consumption by workers of their pension accumulations. Allowing more cash-outs also

would diminish the premium base for the Pension Benefit Guaranty Corporation.

Encourage Pension Preservation for Retirement. The ability to preserve the tax-free status of distributions from tax-qualified pensions has existed since 1975 when rollover IRAs first became effective. Rollover IRAs, however, have not been much used, although that may change in the future as the effects of the 1986 Tax Reform Act are felt. Tax reform largely eliminated favorable treatment for lump-sum distributions, and it imposed a 10 percent additional tax on certain uses of the proceeds from any qualified plan or IRA. These steps, by themselves, may cause more people to use the rollover IRA option.

Additional restrictions could be placed on the preretirement use of accrued pension rights. For example, tax-qualified pensions could be required to place any preretirement distribution into a rollover IRA. Alternatively, pensions could be prevented from cashing out workers whose accrued benefits exceed a particular dollar level. At the same time, the additional tax on preretirement uses of plan distributions or rollover IRAs could be increased. These restrictions, however, still would not prevent individuals, especially those in the top half of the income distribution, from borrowing against their other assets--especially their houses--in the amount of the accrued pension benefits that they cannot directly use. It is questionable, therefore, whether such restrictions could actually force people to save more for retirement.

CONCLUSION

In conclusion, I wish to emphasize four points. First, the current pension system poses serious issues of tax equity. In particular, people with equivalent lifetime incomes may get very different gains in retirement income from the tax advantages of qualified plans, depending on their work histories. Second, the principal reason for these disparities is the way that defined benefit plans--the mainstay of the current pension system--operate. Those who change jobs more often and later in life generally receive less from defined benefit plans than those who work for fewer employers. Restructuring defined benefit plans to increase service portability, or its equivalent, could provide more equitable treatment for mobile workers, but would have considerable and unclear effects on labor markets. Third, changes in asset portability will not fundamentally alter the pension amounts available at retirement. Finally, though the issue of pension portability will continue to pose a public policy dilemma, it may begin to resolve itself over time if more employers and workers begin to voluntarily shift toward defined contribution plans, at least in the form of supplementary retirement savings.

Chairman PICKLE. Thank you.

First, let me say that the staff has a series of written questions we may submit to you, and which we would like for you to respond to in writing as soon as you can.

Second, I would like to say to the audience that we have witnesses this morning, this panel and then from the Departments of Labor and Treasury, a panel consisting of several different organizations, two different panels of that nature.

We intend to continue on until noon or 12:30. We will have an afternoon session also on investment of pensions assets primarily. That is to commence at 1 o'clock, and I believe that meeting will be in B-318.

I mention this because we have a lot of witnesses and we may not be able to ask as many questions as we might normally want.

The testimony and the examples that both of you have given us are very meaningful. Our staff has looked at them and we have had a chance to look over the testimony and analysis, and it is very good.

I notice, Mr. Delfico, you say in your testimony, and Ms. Marcuss also in your table 1, essentially that in the defined benefit plan, a person who changes job several times is going to get less on retirement.

That must be an obvious fact, but I am surprised, Mr. Delfico, you said that the job mobility loss is 49 percent in a job career.

Mr. DELFICO. That is correct for the example we used here.

Chairman PICKLE. By comparison, the employee with a defined contribution plan would have a pension benefit about 23 percent higher than the mobile employee with a defined benefit plan.

Mr. DELFICO. That is correct.

Chairman PICKLE. It would seem to me that means that the defined benefit participants are destined for less retirement funds inevitably if they change jobs several times.

Do I interpret your statement to show that in a defined benefit plan, the loss could be about 49 percent?

Mr. DELFICO. That is correct, Mr. Chairman. That is what we have used in our example here.

I should say it all depends on the assumptions we use in the example. For example, the defined contribution plan may not perform as well as we assumed if the rate of return used in this particular example is too high.

We thought it was conservative. I think it was between 4 and 6 percent.

The Congressional Research Service did this for us. We worked with them in our analysis.

The pension from a defined contribution plan basically falls in the middle of our chart between a stable employee and one who moves around quite a bit.

Chairman PICKLE. Ms. Marcuss, you say the same thing, table 1, an employee staying on the same job is going to get considerably more than one who changes.

Yet, mobility is inevitable. People do change by necessity many times. That is a fact of life.

As we recognize the disparity between the two, we have to look for ways to equate that if possible, and that is going to be difficult to do. We may never be able to do it.

Has anybody proposed requiring an employer to credit the worker's years of service with previous employers? Would that cost the employer a great deal of money?

Is that practical?

Mr. DELFICO. It is probably one of the least practical of the solutions that we have looked at. I don't think there is a proposal precisely directed at that particular issue now being considered by Congress. It has been talked about theoretically and it is probably going to be costly administratively.

One of the problems with that kind of a scheme is that the final employer would bear the burden of the pension payout because of the service transfer to that particular employer and would want to be compensated somehow so you would have to develop a method for compensating that particular employer, whether it be previous employers compensating or the Federal Government stepping in.

Chairman PICKLE. Is it correct to say that defined benefit pension plans by their design intentionally discriminate against the short-term employee in favor of the long term?

Ms. MARCUSS. Another way of putting that would be to say that the defined benefit plan is designed to reward long tenure in one job and therefore, by definition, it is relatively less generous for short-term workers.

However, workers and employers have chosen a defined benefit plan as their major pension plan because such plans seem to answer the interest of employers to create incentives for long tenure by employees. Thus, they are designed specifically to reward that longer tenure.

Chairman PICKLE. What do we do?

We recognize there are two systems that you can choose whichever one you want and overall the system has worked well.

Do either of you have a recommendation what this committee or what the law should be or——

Mr. DELFICO. We have talked about this for hours and maybe even weeks prior to this testimony because we all anticipated this kind of question and there is no answer as we have seen it because there is no right answer to the situation. The costs clearly have to be analyzed.

The Federal Government is going to get involved somewhere, whether in the tax system or administratively to make some of these pension proposals work and that has to be analyzed.

There is an impact on the employer that has to be examined.

Ms. MARCUSS. I think the cost of getting rid of these inequities is very high and would have substantial effects on the labor market. Major initiatives that would not allow existing discrepancies would have far-reaching effects and, therefore, need to be considered carefully before being undertaken.

Chairman PICKLE. Mr. Schulze?

Mr. SCHULZE. Thank you both for your testimony.

I get the impression that you view this issue as a mine field with a lot of mines out there and we don't know which one we are going

to step on or how they will react when they go off. Therefore, we should give it a great deal of consideration.

Is that correct?

Mr. DELFICO. That is correct.

Mr. SCHULZE. Someone told me of an LTV defined benefit case where an executive or several executives bailed out of the program and took so much of the assets of that plan, that it left the rest of the participants holding the bag. That is a major negative against portability.

Are either of you familiar with that situation?

Mr. DELFICO. I am not familiar with that particular case.

Mr. SCHULZE. Perhaps I shouldn't have said LTV because I am not sure it was, but I heard it. Is that kind of thing possible? What I am leading up to is this, is there a way to game the system? Is there a method wherein someone could work for one employer and actually plot this type of action to game the pension structure? If so, we ought to be very careful that we do not encourage this.

Ms. MARCUSS. There are quite complex rules to try to promote the most equitable receipt of pensions under both defined benefit and defined contribution plans now. So there already has been much effort to address these issues. But both types of plans continue to bear risks. They are different risks, but there are risks to the employees in each kind of plan.

Mr. SCHULZE. Ms. Marcuss, with your knowledge, if you set out deliberately to game the pension structure—do you think that you could do it or has it not yet reached that point of sophistication.

Ms. MARCUSS. From the perspective of a Government employee, it is hard to see how I could game the system. Certainly, there are ways to maximize the tax advantages, but the central characteristic of the U.S. pension system is that it is voluntary and employer-provided and is already subject to a significant amount of rules. How far you can push those rules to create more equity is a very difficult issue because at some point you are in danger of causing the system to shut down or at least to begin to reduce coverage rather than increase coverage for workers.

Mr. SCHULZE. Mr. Delfico, do you have a response to that question?

Mr. DELFICO. I think you would probably have a better chance to game the system if one was in a small pension plan, a privately held company.

I know the Congress has been concerned about compensation of the higher paid employees in these plans, but if there is a chance it would be in small pension plans and in privately owned companies, ESOPs, and plans like that.

Mr. SCHULZE. How about the effect of all of this on small business? I didn't notice any such discussion in your testimony. Did you not try to segregate small pension plans versus large pension plans or small business versus larger business?

Ms. MARCUSS. One characteristic of the system is that most of the defined benefit plans, which operate under much more complex rules, are sponsored by large companies. Defined contribution plans tend to be more common in smaller companies because they are much easier to set up and maintain.

Mr. DELFICO. And most small businesses may not have a pension plan nowadays.

Mr. SCHULZE. Thank you both for your testimony.

Thank you, Mr. Chairman.

Mr. ANTHONY [presiding]. I would like to follow up on a comment that you made to Mr. Schulze, and was his concern about "gaming the system." You mentioned small, privately held companies that would voluntarily establish a pension plan, and you also mentioned ESOPs. It has been my experience that over the last few years the Congress has addressed over and over again the nondiscrimination rules, the vesting requirements and a multitude of other technical areas.

The tax reform bill of 1986 looked at these questions again, and the whole idea was to try to make sure that there was fairness of distribution between the janitor and the CEO or the CEO's son. Do you feel that we, in fact, have been able to take out some of those abuses if, in fact, they were there?

Mr. DELFICO. Yes, I do. I think that has happened over the past couple of years. As I mentioned, the Congress has been very interested in working on it. I don't think it is possible to do it 100 percent, but I think you are going in the right direction.

Mr. ANTHONY. Also, in the ESOP area?

Mr. DELFICO. Not as much there, but there is quite a bit of interest, I know, on the House side on ESOPs.

Mr. ANTHONY. On the pro side, I might add, not the negative side.

Mr. DELFICO. Just interest, period.

Mr. ANTHONY. You happen to be talking to one of the stronger advocates of ESOPs and plans for small employers. My experience has been that rather than going far enough, we may have gone too far. What I have found in 1987 is we had a lot of pension plans that were terminated as a result of what happened in 1986, a lot of small employers have gone to some of the SEPS, and some of the other plans, because of the regulations that we have placed on them.

The main reason I brought it to your attention, I didn't want the record to be silent in terms of thinking that maybe there is still a lot of abuse out there, because I think the Congress has really addressed that area.

I do have some questions to both of you. It is a complicated subject matter, and your testimony was very explicit in a lot of areas. If you were asked just to summarize or just mention two main problems or issues with the current lack of a pension plan portability, where would you put——

Mr. DELFICO. I would say probably the main problem with lack of portability is the freezing of assets in a defined benefit plan.

Mr. ANTHONY. Freezing of assets——

Mr. DELFICO. Freezing assets of the benefits in a defined benefit plan for the individual who moves and does not see the effect of inflation on their benefits. That is what causes a good part of the differences between one who stays and one who moves around quite a bit.

So, I would say that indexes——

Mr. ANTHONY. That would be your top problem, would be the freezing, the deterioration due to inflation?

Mr. DELFICO. That is one of about three issues, but that would be one of my top.

Ms. MARCUSS. I would consider that to be one of the biggest issues because defined benefit plans are the mainstay of the current private pension system. A topic not discussed today is coverage. Only 50 percent of the labor force is currently covered. This lack of coverage also affects adequacy of retirement income. I would agree, however, that inflation's effects on the experience of early leavers in defined benefit plans has the largest impact on depreciating their retirement income.

Mr. ANTHONY. You mentioned underportability and underservice, but for vesting——

Ms. MARCUSS. To the extent that employees are not vested in a defined contribution plan, they do not really have the functional equivalent of service portability, but once they are vested, they do.

Mr. ANTHONY. But I took your testimony to say that there were a lot of differences in the way people could vest, and as a result, you ended up with distortions in the labor force as to who was covered.

Ms. MARCUSS. The Tax Reform Act did shorten mandatory vesting periods, and it is hard to see what additional return you would get from squeezing those down much further. There is a certain amount of turnover in jobs among young people that is persistent and is not going to change.

Mr. ANTHONY. Are both of you aware of the contents of H.R. 1961?

Mr. DELFICO. To some degree, yes.

Mr. ANTHONY. Does H.R. 1961 address any of the problems that you have just mentioned, or the other problems contained in your testimony?

Ms. MARCUSS. It addresses the issue of asset portability—the ability to retain the tax-advantaged value of accrued benefits at the time of leaving a firm.

Mr. ANTHONY. Would you say that it is a comprehensive approach or a limited approach?

Mr. DELFICO. I would say it is a limited approach in that it deals with preservation issues only.

It doesn't deal with the service issue, the portability of service issue, and it doesn't deal with the issue of indexing frozen benefits that I mentioned earlier.

Mr. ANTHONY. Those other two are major problems in the pension system?

Mr. DELFICO. Yes.

Mr. ANTHONY. So, H.R. 1961 doesn't really address some of the more serious concerns within the pension system?

Mr. DELFICO. That is correct.

Mr. ANTHONY. So to that extent, it would be very limited?

Ms. MARCUSS. It is inherently difficult to force savings for retirements, even with a mandatory rollover to an IRA. Many workers could borrow against their other assets to offset the forced savings.

Mr. ANTHONY. So, if H.R. 1961 was billed as a comprehensive piece of legislation that could really solve some of these problems,

that wouldn't necessarily be reflective of the true problems of the system?

Mr. DELFICO. That is correct.

Mr. ANTHONY. So, you would caution anybody that cosponsors or works on something that limited in nature?

Mr. DELFICO. I would say it is a step toward portability and preservation, a small step, but I wouldn't characterize it as being the last word in that area. It is just a beginning.

Mr. ANTHONY. A small step?

Mr. DELFICO. Yes.

Mr. ANTHONY. I would yield to Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

I am not going to belabor the panel with questions. I want to thank you for coming. Certainly I have a real personal interest in this kind of legislation. I am vested in three different retirement systems, but I probably am not going to be able to retire from any one of them with the number of years necessary to get a reasonable retirement annuity because of the constraints of salary at the time of my leaving employment and the limited number of years.

So, this is an important issue. I believe your testimony today has provided great insight into the problem. We are certainly going to be looking at some solutions such as contained in your testimony and others who will follow you today.

So, I want to thank you.

Mr. ANTHONY. Thank you very much for your contribution.

Our next panel is the U.S. Department of Labor, represented by David Walker, Assistant Secretary for Pension Welfare Benefits; the U.S. Department of the Treasury, represented by Harry J. Conaway, Associate Tax Legislative Counsel.

If you gentlemen would move forward to the witness table, I understand that Gene Steuerle will be representing the Treasury. You have heard Chairman Pickle's statement that your entire testimony will be considered part of the record, and you are permitted to proceed as you wish. Thank you for coming.

STATEMENT OF DAVID M. WALKER, ASSISTANT SECRETARY FOR PENSION AND WELFARE BENEFITS, U.S. DEPARTMENT OF LABOR

Mr. WALKER. Thank you, Mr. Anthony.

I am David M. Walker, Assistant Secretary of Labor for Pension and Welfare Benefit Programs. I appreciate your submitting my entire written statement for the record. I would now like to summarize that statement for you and the other subcommittee members.

I would also like to acknowledge the presence of Ann Combs, Gary Hendricks, Anthony Knettel, and Jerry Lindrew, who were instrumental in preparing our testimony today. Per the committee's request, my testimony includes a comprehensive description of our study on pension portability losses, which was conducted by Hay/Huggins Associates and paid for by the Department of Labor.

This study, which will be released within the next few days, examines the impact of job mobility on a worker's final pension benefits. It also examines various options for enhancing pension porta-

bility and concludes that modest reductions in pension portability losses can be accomplished at relatively little cost to plan sponsors.

However, approaches which would result in significant reductions in portability losses would be extremely costly to plan sponsors and could discourage pension coverage and reduce incentives for employers' training and retraining of workers, among other things.

As a result, while portability represents an important pension policy issue, the study underscores the need to proceed with caution in order to achieve positive results while avoiding any land mines which would have counterproductive consequences.

Before discussing the study, I would like to take a moment to put this issue in its appropriate context. First, there is little question that pension portability is an important issue, especially given our mobile work force. At the same time, portability represents only one of many pension issues which contribute to an adequate and secure level of retirement income.

In fact, in addition to funding and termination issues, at least three major factors relating to private pension systems contribute to overall retirement income adequacy and security.

They are pension coverage, entitlement, and preservation of pension benefits for retirement income purposes. Of these, the lack of pension coverage remains the most fundamental and stubborn obstacle to assuring that workers receive a pension.

For example, while an additional 6.2 million Americans have obtained pension coverage during this Administration, millions more are not covered. In fact, as of December 31, 1987, 46 percent of full-time private wage and salary workers were not covered by an employer-provided pension.

In addition, the coverage issue is of particular concern in the small business sector and among part-time workers. Clearly, the coverage issue is of fundamental concern, since if workers are not covered by a pension plan, such issues as benefit entitlement, equity, security, portability and preservation of benefits are in effect moot.

Nevertheless, pension benefit losses, in particular portability losses, which will result from moving from job to job, should not be ignored or underestimated, especially given our mobile work force.

What are portability losses? Well, for the purpose of the Department study, portability losses were measured in terms of the loss of pension benefits resulting from job mobility. The study used a model based upon representative job histories of the current population and current turnover trends.

The study compared two pension amounts, one earned by a worker who would be covered under several pension plans during his entire career, which is of growing frequency, and the other pension amount earned as a result of a worker participating in one pension plan throughout his entire career. Specifically, the amount earned under the last pension plan he participated in was used for this comparison.

The study calls the second amount, the one that the individual would earn through working for one employer throughout his career, the single career benefit. As a result of comparing the two

amounts, the study identified three major causes of portability losses.

First, failure to vest in a pension benefit; second, pre-retirement consumption of pension lump-sum distributions; third, certain pension plan characteristics.

The first two causes, failure to vest and pre-retirement consumption of pension savings, relate to pension benefits earned both under defined benefit and defined contribution pension plans.

The third cause, which the study notes is the primary cause for portability losses, only relates to defined benefit plans. It should be noted that defined benefit plans and issues related to defined benefit plans represent 75 percent of potential portability losses in the universe, as the study notes.

There are, however, other possible pension benefit losses that are not covered by the study. For example, the study measures portability losses only by workers covered by pension plans during their entire careers, beginning from the point where they participated in their first plans. It, therefore, does not reflect job histories of workers who lose pension coverage in midcareer.

I would now like to turn to the study's findings with respect to the magnitude of these portability losses. First, I think it is important to note that the study shows that 41 percent of the covered work force experiences insignificant, if any portability loss. This 41 percent represents workers covered by defined benefit plans who remain on the same job for 35 years or more as well as workers who are covered by defined contribution plans during their entire career.

As I previously noted, the study demonstrated that portability losses are largely a phenomenon of defined benefit pension plans.

Among the 59 percent of covered workers in the model who do experience some portability loss, the average loss was 25 percent of their single career benefit. However, the average can be misleading, since there is a significant range of losses and dispersions from that mean. For example, 8 percent of these workers lost less than 10 percent of their single career benefit, while 10 percent lost between 40 and 49 percent of their single career benefit.

The study notes that it is theoretically possible for losses to occur in excess of 50 percent, but losses of such magnitude should be extremely rare.

I would like to describe now what the study reveals about ways that portability losses might be reduced. First, the study describes two major options for significantly reducing portability losses. One possible approach which is discussed periodically would require employers to index the pension benefits of vested workers who have left the company.

A second would require employers to give pension credit for all service under previous pension plans and then offset any prior pension benefits. These are not approaches we recommend.

These are approaches that have been discussed, including earlier in this hearing. Both of these solutions would greatly reduce portability losses. For example, if benefits were indexed to the Consumer Price Index, the average loss for all covered workers would drop from 15 percent to 5 percent of the single career benefit, or a re-

duction from an average loss of 25 percent for those persons who have a portability loss to 8.25 percent.

If employers provided credit for any employee's total pension coverage service, with an offset, portability losses could be almost entirely eliminated. That is the good news, but there is bad news.

It must, however, be noted that while reducing portability losses, these two approaches would do so at a substantial cost to employers who maintain defined benefit pension plans. Faced with a substantial increase in cost, employers are less likely to set up or maintain defined benefit pension plans.

This would be a matter of significant concern, since defined benefit plans provide greater benefit security and certainty and are insured by the Pension Benefit Guaranty Corporation. In addition, employers that remain under the defined benefit system would be likely to lower benefit levels in order to absorb the increased cost.

Furthermore, these approaches would lead to many workers getting windfall gains, portability gains, if you will, and may have the additional adverse effect of encouraging turnover or discouraging the hiring of older workers, matters that would be a matter of great public policy concern.

The study also examined other less costly ways of reducing portability losses. One such approach would be to require more rapid vesting. The vast majority of workers will be subject to reduced vesting standards, down to a 5-year minimum vesting period as a result of the Tax Reform Act of 1986, effective January 1, 1989.

The study does note, however, that requiring full and immediate vesting would do little to offset portability losses. However, the 10-year vesting standard still applies to multiemployer pension plans.

Therefore, applying the 5-year vesting standards to multiemployer pension plans would decrease portability losses and improve pension equity for the 13 percent of covered workers in these plans.

It would also improve the equity of our private pension system by ensuring that all workers in tax qualified plans are subject to the same minimum vesting standards, thereby creating a level playing field. There are 8 to 9 million Americans in multiemployer plans who without a legislative change are not going to be afforded the reduced vesting standards applicable to most plans in the universe.

The study shows that taking additional actions designed to encourage or require individuals to preserve pension savings for retirement income purposes would result in a moderate reduction in overall portability losses at little cost to plan sponsors.

With the proliferation of supplemental defined contribution plans, actions that encourage preservation of retirement savings may become even more effective in reducing portability losses in the future.

For example, 40 percent of covered workers at present also participate in supplemental defined contribution plans, and this number is increasing rapidly.

In conclusion, pension portability represents an important pension policy issue, especially given our mobile work force. It is, however, only one of many pension policy issues that contribute to an adequate and secure level of retirement income to workers.

The most fundamental of these issues is how to expand pension coverage, especially in the small business sector and among part-time workers. We believe that the Department's study will provide valuable information regarding the effectiveness and implications of any proposals being considered by Congress and this committee, and in addressing pension portability and preservation issues in general.

Finally, as the study notes, while the issue of pension portability is an important one deserving of our attention, the Congress needs to proceed with caution in order to avoid taking actions that, while enhancing pension portability, might have other inappropriate or counterproductive consequences. For example, we must assure that any approaches designed to enhance pension portability don't do so at the cost of reducing overall coverage, compromising benefit security, discouraging defined benefit plans or discouraging the hiring of older workers.

This concludes my remarks, and I would be happy to respond to any questions that you may have.

[The statement of Mr. Walker follows:]

STATEMENT OF DAVID M. WALKER, CPA
ASSISTANT SECRETARY FOR PENSION AND WELFARE BENEFITS
U.S. DEPARTMENT OF LABOR
BEFORE THE
WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT
U.S. HOUSE OF REPRESENTATIVES

July 12, 1988

I. Introduction:

Thank you, Mr. Chairman, for inviting me to testify today. I am David M. Walker, Assistant Secretary for Pension and Welfare Benefits, U.S. Department of Labor.

The purpose of my statement today is to summarize the findings of a study conducted by Hay/Huggins Associates, at the request of the Department of Labor, which will soon be published by the Department. This study examines the impact of job mobility on final pension benefit receipt -- what the study refers to as "portability losses". It concludes that although modest reductions in portability losses could be accomplished at relatively little expense, significant reductions in such lossess could only be accomplished at substantial increased expense to employers and/or long-tenure employees.

Before I discuss the study in more detail, however, I would like to take a moment to put this issue into an appropriate context.

There are four interrelated factors which contribute to retirement income security. They are: coverage, entitlement, portability, and preservation of benefits for retirement. Of these four, the lack of pension plan coverage for a substantial portion of the work force is perhaps the most important and fundamental obstacle to pension benefit receipt. This study focused on losses of pension benefits resulting from movement from one pension plan to another, which often occurs given the mobility of our work force.

The term "portability" means different things to different people. Therefore, I will begin my summary of the Department's study by discussing how "portability" was defined.

II. What is Portability?

For purposes of the Department's study, portability was measured in terms of pension benefit losses resulting from job mobility. The study utilized a model based on a limited but reasonably representative set of job histories of primary pension plan coverage, rather than hypothetical illustrations.

The model measured the "portability loss" resulting from a worker changing jobs by comparing two pension benefit amounts. The first amount was the total benefits accured by a worker under a succession of pension plans during his or her job history. The second amount was the total benefits that the worker would have accrued had he or she been covered during his or her entire job history under one pension plan -- what the study calls a "single career benefit". This model determines the single career benefit by using the benefit formula of the last pension plan under which the worker was covered. This comparison was made for each of the job histories in the model.

Having described how the study measured portability losses, I would like to briefly discuss the major causes of portability losses examined by the study.

III. How Do Portability Losses Arise?

The study identifies three major causes of portability losses. They are: (A) a worker's failure to vest in a nonforfeitable pension benefit; (B) certain pension plan design characteristics; and (c) pre-retirement consumption of plan distributions. I will briefly address each factor.

A pension plan's vesting requirements may contribute to portability losses. Most pension plans require several years of service before a worker participating in the plan vests in a nonforfeitable pension benefit. As vesting periods lengthen, the likelihood decreases that short-tenure workers will accumulate sufficient service to vest in a pension benefit before moving to his or her next employer. Many employers regard delayed vesting as an important tool to promote work force stability.

Plan design characteristics may also cause portability losses. Some plans reward longer service at the expense of short-tenure mobile employees. Because pension plan sponsors typically do not index the vested benefits of separated workers to inflation, the value of these benefits is eroded by inflation during the period between separation and retirement. Other plan design characteristics also affect the benefits received by separated workers. For example, many defined pension plans use a benefit formula based on a worker's final average pay. Separation from service earlier in a career results in the benefit being based on a salary that is almost always lower than that earned at the end of a career. Thus, the inability of an employee to accrue benefits at a time when final average pay plans maximize such accurals can result in lower pension benefit receipt in retirement.

The failure of separated employees to preserve their vested benefits for retirement is a third significant factor affecting pension benefit receipt. Recent research suggests that employees who receive their benefits as a lump-sum are unlikely to save the benefits for retirement by rolling them over into an IRA or another plan. While this is generally the case for employees who elect voluntarily to receive lump-sum benefits, it is especially true of those receiving involuntary cash-outs of benefits with a present value less than $3,500.

Having discussed the three major causes of portability losses in general, I would like to now focus our attention on what the Department's study tells us about the magnitude of these losses.

IV. What Do We Know About The Magnitude Of Portability Losses?

Portability, by its nature, applies to workers who are already covered by a pension plan and are moving between plans. When we talk about the magnitude of portability losses, we are distinguishing such losses from the broader coverage issue I mentioned earlier -- namely, the effect that the lack of pension coverage experienced by a portion of the work force has on ultimate pension benefit entitlement and receipt. Keeping this distinction in mind, what does the study tell us specifically about portability losses?

First, workers remaining with the same employer for 35 years or more, plus those workers covered by defined contribution plans their entire career -- 41 percent of the total covered work force -- experience little or no portability losses. This indicates that portability losses are principally experienced by shorter service workers who are covered under defined benefit pension plans.

Second, among those covered workers experiencing some portability loss (59 percent of workers in the model), the average loss was 25 perent of the single career benefit. Eight percent of these workers had losses of less than 10 percent of the single career benefit, while 10 percent had losses of 40 to 49 percent of the single career benefit. Although portability losses above 50 percent are possible for unusual mobility and coverage patterns, losses of such magnitude are infrequent. Under most defined benefit pension plans, as much as 50 percent of a worker's benefit is earned in the 10 years prior to reaching eligibility for retirement. Thus nearly half of a worker's retirement benefit is likely to be provided by the last employer.

With some sense of the study's findings with respect to the magnitude of portability losses, I would like to turn now to what the study tells us about possible means of reducing portability losses.

V. What Do We Know About Reducing Portability Losses?

I previously identified principal causes of portability losses: failure to vest, characteristics of plan design, and pre-retirement consumption of benefits. Let us consider what the study said about how taking certain actions relating to each of these contributing factors could serve to ameliorate total portability losses.

Failure to vest: the study found that vesting standards shorter than 5 years would slightly decrease portability losses. The reduction in the single career benefit loss would be about one percentage point.

Some commentators have proposed the further reduction of minimum vesting standards in defined contribution plans as means to reduce portability losses. Similarly, it has also been proposed that the minimum vesting standards for multiemployer defined benefit pension plans be reduced to match single employer plan standards. The study suggests that such incremental changes would have relatively little impact on overall portability losses, even though some additional workers (especially those covered by multiemployer plans) who would otherwise be entitled to no benefits would become entitled to benefits.

Plan design characteristics: the study indicates that at least 75 percent of all portability losses are the result of design characteristics of defined benefit plans. Indexing the vested benefits of separated participants to inflation could eliminate up to two-thirds of total portability losses. Indexing to general wage growth would not only largely eliminate portability losses for most workers, but in some cases would produce a portability windfall. In other words, it is possible that under certain circumstances employees who changed jobs frequently could earn greater total benefits than a worker who stayed with a single employer.

Similarly, a requirement that employers credit all service under preceding plans (offsetting the benefit received from those plans) would effectively eliminate portability losses. This approach, like others that significantly reduce portability losses from defined benefit plans, would be very costly to employers. For example, crediting service with former employers would increase the pension costs of the final employer by 25 to 50 percent for workers hired after age 45. This would add a significant barrier to hiring older workers.

These two approaches -- indexing benefits or requiring past service credits -- would reduce or eliminate portability losses at substantial increased expense to employers. Moreover, in the case of required past service credit, a fundamental

alteration of the structure of pension plans would result. The substantial expense required to eliminate portability losses suggests that efforts to eliminate them could cause employers to offset the expense by lowering overall benefit levels for long-term plan participants. Alternatively, some employers might feel compelled to substitute defined contribution arrangements for defined benefit pension plans, thereby shifting plan investment risks to employees and depriving them of the federal insurance program provided to defined benefit plans by the Pension Benefit Guaranty Corporation.

An employer's use of a defined benefit pension plan as a work force management tool produces a dilemma. Those elements of plan design that lead to portability losses are precisely those elements that employers view as effective work force management devices to encourage loyalty and longevity of service. An appropriate balance needs to be found between lowering barriers to reasonable work force mobility on the one hand, and encouraging unnecessary turnover on the other.

Because portability losses are largely a result of an employee's movement in and out of defined benefit pension plans, other commentators have proposed that employers be required to provide minimum defined contribution benefits to covered workers. This option addresses the problem, not by increasing portability among present benefit forms, or even altering the balance of incentives between defined benefit and defined contribution plans, but by changing the fundamental structure of the current voluntary private pension system. It also has significant cost implications for employers and revenue loss implications for the Government. If, for instance, an employer replaced a defined benefit plan that costs 10 percent of salary with a defined contribution plan, the retirement benefits for a full career employee would have to be lowered by 30 percent to keep the cost of the plan at 10 percent of salary for a typical group of workers.

Preservation of benefits for retirement: the study also estimates the impact of pre-retirement consumption of involuntary cash-outs of benefits with present values less than $3,500, as well as the pre-retirement consumption of elective cash-outs of amounts in excess of $3,500. It found that involuntary cash-outs of amounts less than $3,500 generally represent a small portion of total career benefits. Therefore, mandatory roll-over of such amounts in an IRA or another plan would have only marginal effects on average portabilty losses, on the order of a one percentage point decrease.

We do not know the precise proportion of workers actually exercising their options to receive benefits in the form of a lump-sum, nor their likelihood to consume rather than save such cash-outs. Data from the Current Population Survey, now being collected, will soon provide us with better information about actual behavior. It will also, for the first time, provide us with data regarding the degree to which cash-out behavior may have begun to change in response to the pension provisions of the Tax Reform Act of 1986.

Currently, roughly one in four workers is covered by a primary pension plan that permits a full cash-out of benefits in excess of $3,500 at separation prior to retirement (an estimated 10 percent of defined benefit plans and 81 percent of defined contribution plans). The study's model projects that the consumption of all potentially available elective lump-sum benefits from primary plans would increase portability losses 5 percentage points, raising the average loss from 15 to 20 percent of a single career benefit for all covered workers. Although the frequency of cash-outs in primary plans seems to be increasing, and most supplementary plans have been designed to provide lump-sum benefits, in reality, not

all these benefits will be distributed as lump sums, and therefore, the portability loss is likely to be somewhat smaller than the model suggests.

Some have suggested that all pre-retirement lump-sum distributions attributable to employer contributions should be disallowed except in cases of "extreme hardship" to preserve such savings for retirement purposes. Using this study as a guide, it appears that this proposal might result in a modest reduction in total portability losses. Others have suggested their portability would be enhanced by providing that vested defined contribution plan participants have the right, at separation, to elect to roll-over their account balances to an IRA or the defined contribution plan of a subsequent employer, and that employers be required to make and accept such transfers. Likewise, some have suggested that defined benefit plan participants be allowed to transfer the present value of their vested benefits (except where this would have an adverse impact on a plan's funded status) to an IRA or successor defined contribution plan. The study indicates that little or no impact on portability losses would result from these two proposals.

In summary: the findings of the study must be viewed in light of the study's overall limitations. This model only includes primary plan coverage; therefore, it does not reflect the fact that approximately 40 percent of covered employees also participate in supplemental benefit plans. Ninety-nine percent of supplemental plans are defined contribution plans, and are by their nature largely immune to portability losses. In effect these supplemental plans provide some cushion against portability losses from primary plans.

The study also does not reflect all the factors involved in an employee's decision to change jobs, which may include reasons more significant than, or unrelated to, projected pension benefits (e.g., current compensation, job enrichment, career change, upward mobility, job location, etc.). Nor should the inference be drawn from this study that job mobility always serves to decrease pension benefit receipt: when a worker moves from an employer with a minimal pension plan (or none at all) to an employer with a generous plan, pension receipt can actually be enhanced. If, however, the purpose and scope of the study are recognized, its findings provide useful insights into the sources and magnitude of potential portability losses, as well as the possible benefits and costs of alternative proposals for reducing such losses.

VI. Conclusion:

Many commentators have suggested a range of incremental changes to current law that would to some degree mitigate certain portability losses; only a few have been mentioned here as illustrations of the points made by the study. Some of the changes mentioned would be major changes in Government pension policy. To the degree that such changes would expand coverage, enhance benefit entitlement, improve pension equity, or encourage the preservation of benefits for retirement purposes, they may have merits beyond that of merely enhancing portability.

To the extent that such proposals hold implications for the specific issue we are considering today -- portability -- this study will hopefully assist the Subcommittee to answer questions regarding the potential effectiveness of such proposals.

This concludes my prepared remarks. I would be pleased to respond to any questions you may have.

STATEMENT OF C. EUGENE STEUERLE, DEPUTY ASSISTANT SECRETARY FOR TAX ANALYSIS, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY HARRY CONAWAY, ASSOCIATE TAX LEGISLATIVE COUNSEL

Mr. STEUERLE. I would like to thank the committee and the chairman for the opportunity to discuss some of the administration's current views on pension portability.

With me today is Harry Conaway, Associate Tax Legislative Counsel.

Let me begin also by congratulating the subcommittee on holding this hearing.

Pension portability is a subject that warrants serious and in-depth examination by Congress and policymakers, and I am sure today's hearing will make a significant contribution to that important dialog.

As has been noted, the issue of pension portability has often been viewed narrowly as whether employees can take their vested benefits when they leave employers and invest them in other plans or individual retirement accounts.

Viewed more broadly, however, pension portability refers to the differential between the total pension benefit that a short-term mobile employee receives for a working lifetime with many employers and the total pension benefit that a long-term employee receives for the same working lifetime with a single employer.

This benefit differential is often referred to as portability loss.

As an aside, Mr. McGrath, we hope that you will not be a victim of this portability loss as we expect many more fine years of service from you in the Government.

Portability reflects a concern about whether sufficient numbers of this Nation's workers receive meaningful retirement benefits under the private pension system and whether the tax benefits associated with the private system are fairly distributed among various groups of workers, for instance, not just mobile and long-term employees, but young and old employees, highly compensated and non-highly compensated employees both women and men.

Under current law, two employees may start out at equal jobs, do an equal amount of work, and receive the same amount of cash pay.

However, under the voluntary employer-based pension system, they may receive very different levels of pension benefits for the same amount of work.

If women shift employment more often than men, for instance, they will receive smaller total pensions at retirement for the same number of years of work.

The extent of these portability losses will depend upon many factors, some of which are arbitrary, such as the rate of inflation.

At the same time, in evaluating portability issues, one should recognize that pension benefit differentials between mobile and long-term employees do not always reflect market failure or imply that certain groups of employees are being treated unfairly in the larger perspective.

Such benefit differentials may, to an extent, be the result of appropriate employer and employee decisions.

For instance, employers may well prefer specially skilled workers and try to link pension benefits to length of service for those workers, while employees may want to select jobs offering different levels of pension benefits at different points in their life time.

Consistent with this, it is important that employees have a better understanding of their benefit entitlements and rights under defined benefit plans and defined contribution plans.

Informed employees should be better able to make employment decisions and bargain more effectively over the desired mix of cash compensation and pension benefits.

The lack of previous understanding, I think, of many of the issues raised is a major reason why the issue of portability has arisen today.

There are several basic features of a voluntary employer-based pension system that may contribute to pension portability losses for mobile workers and I would like to discuss each briefly since the committee has already dealt with a number of these in depth.

Differentials of pension benefits between long-term and mobile workers may occur because not all employers maintain qualified plans and those employers that do maintain these plans do not necessarily cover all the employees.

While nondiscrimination rules for qualified plans require employers to provide a portion of their low-paid employees with comparable pension benefits, some disparity is allowed to exist in favor of higher paid employees.

The Tax Reform Act of 1986, however, addressed this issue. Pension coverage rules were modified to increase the extent to which an employer's low- and middle-income employees must be provided qualified benefits.

My testimony gives more detail on it.

Moreover, while gaps in pension coverage have contributed to mobile employees' portability losses, research to date has not indicated the frequency with which such gaps lead to major benefit differentials between mobile and long-term employees.

Also, the extent to which coverage changes adopted in the 1986 Act will affect portability losses is as yet uncertain, as the new rules only go into effect in 1989.

Even if a mobile employee is covered under an employer's qualified plan, portability losses for mobile employees may also occur because employers do not all maintain qualified plans that provide comparable levels of benefits.

While disparities of benefit levels obviously contribute to differences in benefits among employees, it is not clear that this factor per se would contribute to a greater likelihood that a mobile employee would incur a portability loss.

A third factor affecting possible portability losses is deferred vesting.

Even if a mobile employee earns a meaningful level of pension benefits under a qualified plan, the plan may require that the employee perform a minimum number of years of service before vesting in his benefits.

In many cases, deferred vesting may also work to the disadvantage of lower paid employees.

To the extent that low- and middle-income workers change jobs more frequently than higher paid employees, the lower paid mobile workers are more likely to lose accrued benefits.

Again, however, the 1986 act attempted to address this issue and reduced the number of years of service that a plan could require for full vesting from 10 years to 5 years except as pointed out by Mr. Walker that multiemployer plans may still require 10 years of service.

The fourth factor affecting portability loses is deferral of pension benefit accruals.

Portability losses for mobile workers typically occur under those pension plans that use computation of benefit formulas based in whole or in part on an employee's years of service or final pay with their employer.

A table attached to my testimony demonstrates how the value of an employee's accrued pension benefit for a year varies by age and by inflation for continuing with an employer for one additional year under a defined benefit plan.

I might point out one difference between this table and the tables presented before.

Most of the prior tables have given you numbers on the actual final benefit or the actual level of benefit for workers at different levels.

This table points out the change in the present value of a pension benefit if a worker remains on the job for one additional year.

If you compare the plans in the table, you will see that under "defined contribution plan," it is typical for an employee of higher age to receive slightly greater pension benefits as he or she ages because that worker is likely to have higher levels of real income.

In a defined benefit plan, we see at a zero inflation rate that a similar factor is involved.

The worker receives higher levels of pension benefits for working an additional year simply because the worker's real income goes up.

However, in addition, the real income increase raises the value of the prior service, thus giving a compound effect and raising the value of the defined benefit plan with age at a faster rate than with a defined contribution plan.

I would like you to also look at the numbers which give the benefit levels for defined benefit plans at higher inflation rates such as the 4 and 8 percent.

If you look at this, you will see that the defined benefit plan in a somewhat arbitrary way quickly shifts the relative benefits received by workers, younger versus older workers, and workers with short and long tenures, relative to different inflation rates.

So as the inflation rate jumps from zero percent to 8 percent in the same defined benefit plan, we see that an employee age 25 has benefits which would have been worth $2,500 at a zero rate of inflation dropped to $400 as a 4-percent rate of inflation and dropped to $84 at an 8-percent inflation.

These are the benefits that a worker receives if he or she stays only one additional year.

My point is that inflation not only has an effect upon portability losses, but it imposes a risk upon employees so that even if one de-

signs a plan which is optimal at a 4-percent inflation rate, it is not clear that it would be an optimal plan at an 8-percent inflation rate or at a zero-percent inflation rate.

In sum, for mobile employees, the value of lost benefits due to deferred benefit accruals is generally much greater than the value of lost benefits attributable to an employee's first few years of service.

In this regard, I would like to reiterate previous commentators' responses to questions and indicate that we believe that this is probably the most important factor affecting the probability losses.

Some commentators argue that the issue of portabilty involves not only differences in vested pension benefits earned by mobile and long-term workers, but also differences in the pension benefits ultimately received at retirement; that is, portability problems can result not only from a mobile employee's failure to accrue benefits, but also from the failure to preserve an accrued benefit as a retirement benefit.

Here again, however, the 1986 act addressed this issue by adopting various rules designed to reduce the extent to which pension benefits are consumed before retirement.

The act applied a 10 percent early distribution tax, eliminated special 10-year averaging for pre-retirement lump distributions and adopted a pro rata basis recovery rule for qualified plans.

These changes are likely to reduce the level of pre-retirement benefit erosion by encouraging mobile employees who do receive pre-retirement distributions to preserve these benefits in IRAs and other plans for retirement.

No matter how attractive the portability label may be, proposals intended to promote portability must be carefully evaluated in light of several important objectives—increasing savings, promoting an efficient allocation of resources, distributing fairly the significant tax benefits associated with private pension plans, and providing meaningful private pension benefits to low- and middle-income employees.

Features of the voluntary employer-based tax-qualified pension system that contribute to portability losses may also provide important benefits more consistent with the objectives set forth above.

For instance, it is difficult to expand coverage or improve benefit levels without also either creating disincentives for employers to maintain qualified plans by increasing employer cost or threatening the voluntary nature of the system.

Proposals to encourage the maintenance of additional qualified plans that provide more meaningful levels of retirement benefits within the context of the voluntary system are likely either to have revenue costs or also to affect adversely benefit funding or discrimination.

Three quick examples: Those who criticize the portability effect of deferred benefit accruals often suggest indexing an employee's benefits for years between preretirement termination of employment and the employee's retirement age.

However, indexing could substantially increase the cost of maintaining defined benefit plans.

A second approach to addressing portability losses is to mandate that defined benefit plans credit an employee's years of service

with all prior employers. In many ways, however, this approach is difficult to implement and impractical given the wide differences among the types of plans. It could also significantly deter employers from hiring older employees.

Third, as noted by Congressman Schulze, mandating portability of underfunded plans could have an adverse effect on the risk of the plans and on the eventual PBGC liabilities.

To further complicate the analysis regarding portability effects of deferred benefit accruals, there is a view that plans providing deferred accruals actually may be beneficial to some mobile employees. By working the last 10 or 15 years under a plan that defers employee's benefit accruals to the years approaching retirement age, a mobile employee is able to earn a significant portion of the pension benefit he would have earned if he had stayed with a single employer.

In conclusion, many believe that the current voluntary employer-based pension system is flawed from a portability perspective. We recognize that despite recent legislative changes, portability remains a very important issue that affects millions of Americans and that the current pension system could be improved to reduce portability losses.

In this connection, many of the legislative proposals under consideration make important contributions to the continuing dialog on portability.

However, they must be evaluated in light of the important economic, tax, and retirement objectives previously discussed.

Time is needed to properly assess also the portability effects of recent changes to the pension law, many of which only become effective in 1989.

Thank you again for this opportunity to present some of the administration's views on pension portability.

I would also be happy to answer any questions you may have.

[The statement of Mr. Steuerle follows:]

Release Upon Delivery
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July 12, 1988

STATEMENT OF
C. EUGENE STEUERLE
DEPUTY ASSISTANT SECRETARY FOR TAX ANALYSIS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

Thank you, Mr. Chairman, for the opportunity today to discuss some of the Administration's current views on pension portability. Let me begin by congratulating you on holding this hearing. Pension portability is a subject that warrants serious and in-depth examination by Congress and other policy-makers, and I am sure that today's hearing will make a significant contribution to that important dialogue.

WHAT IS PENSION PORTABILITY

The issue of pension portability has often been viewed narrowly as whether employees can "take" their full vested benefits with them when they leave employers and invest them in other plans or individual retirement accounts (IRAs). This view of portability is often referred to as portability of assets or cash values. Other common views of pension portability have included portability of benefits and portability of service. Portability of benefits refers primarily to vesting and other eligibility conditions (e.g., age and service conditions applicable to early retirement subsidies) that may cause mobile employees to lose pension benefits when they lose jobs. Finally, portability of service refers generally to the recognition under a defined benefit plan, for participation, vesting, and benefit accrual purposes, of an employee's service for employers other than the employer maintaining the plan.

More recently, commentators have begun to believe that while the concept of portability includes these particular issues, it actually may be a much broader concept that touches on many of the basic features of our voluntary, employer-based private pension system.

Viewed more broadly, pension portability refers to the differential between the total pension benefit that a short-term, mobile employee receives for a working lifetime with many employers and the total pension benefit that a long-term employee receives for the same working lifetime with a single employer. This benefit differential is often referred to as a portability loss. Because many workers do not remain with a single employer for their entire working lifetimes, or in many cases even for their last 15 working years, portability actually reflects a concern about whether sufficient numbers of this nation's workers receive meaningful retirement benefits under the private pension system. Also, portability reflects a concern about whether the tax benefits associated with the private system are fairly distributed among various groups of workers--for example, mobile and long-term employees, young and old employees, highly compensated and non-highly compensated employees, and women and men.

Under current law, two employees may start out at equal jobs, do an equal amount of work, and receive the same amount of

cash pay. However, under the voluntary, employer-based pension system, they may receive very different levels of pension benefits for the same amount of work. If women shift employment more often than men, for instance, they will receive smaller total pensions at retirement for the same number of years of work. The extent of these portability losses will depend upon many factors, including, for example, the future rate of inflation.

The issue of portability centers broadly on what is considered a "fair" differential of lifetime pension benefits between mobile and less-mobile workers. If one tries to determine what is "fair" by examining the pension rules established by Congress, it is difficult to come to a conclusion. For example, under the typical defined contribution plan, fairness generally is determined by providing employees with contributions that are an equal proportion of current pay. Under a typical defined benefit plan, however, "fairness" is often based on the provision of an equal replacement rate on a service and pay base approximating final salary or salary in the employee's peak earning years.

While these defined contribution and defined benefit formulas might sound similar in concept, in practical terms they can have enormously different impacts on mobile employees relative to long-term employees. Defined benefit formulas often result in little or no real accrual of benefits to the mobile employee, especially in their young and middle years. Moreover, these formulas produce benefits that are much more subject to the vagaries of such factors as inflation. For example, although the typical defined benefit formulas may at low inflation rates strike an appropriate balance between mobile and long-term workers, at higher inflation rates these formulas may excessively favor the long-term workers.

In evaluating portability issues and proposals, one should recognize that pension benefit differentials between mobile and long-term employees do not always reflect market failures or imply that certain groups of employees are being treated unfairly in the larger perspective. Such benefit differentials may to an extent be the result of appropriate employer decisions to maintain plans providing different amounts or forms of pension benefits and of appropriate employee decisions to seek employment offering different mixes of pension benefits, cash pay, and other benefits.

For example, employers requiring specially skilled workers may well prefer to link pension benefits to length of service, such as through deferred vesting or deferred benefit accruals, in order to retain such skilled workers. Other employers requiring employees with more general skills, however, may have less incentive to reward employees to stay for longer periods of time. Similarly, for a variety of reasons (e.g., need for cash income or other benefits). employees may appropriately select jobs offering different levels of pension benefits. Also, to gain the greater benefit security offered by properly funded and PBGC-insured defined benefit plans relative to defined contribution plans, employees may favor employment providing defined benefit plan coverage over employment with an employer that maintains only a defined contribution plan.

Consistent with this, it is important that employees have a better understanding of their benefit entitlements and rights under defined benefit plans and defined contribution plans. Informed employees should be better able to make employment decisions and bargain more effectively over the desired mix of cash compensation and pension benefits.

The following discussion surveys the basic features of the voluntary, employer-based private pension system that may contribute to pension portability losses for mobile workers.

GAPS IN PENSION COVERAGE

Differentials of pension benefits between long-term workers and mobile workers may first occur because not all employers maintain qualified plans and those employers that do maintain plans do not necessarily cover all of their employees. Thus, many mobile employees are likely not be covered under qualified plans for some portion of their working lifetimes.

Gaps in pension coverage generally are more common among lower-paid workers in part because such workers may value retirement benefits relative to cash compensation less than do higher-paid workers. Nondiscrimination rules for qualified plans, for broad social and tax equity reasons, nonetheless require employers to provide a portion of their lower-paid employees with comparable pension benefits. Still, some disparity of pension coverage is allowed to exist in favor of higher-paid employees. For example, under current law, an employer that provides pension benefits to 100 percent of its highly compensated employees (generally, employees who have at least a 5 percent ownership interest in the employer and employees who earn over $50,000) need provide comparable pension benefits to only 70 percent of the employer's non-highly compensated employees.

Furthermore, it is common even for employers that maintain broad-based qualified plans to exclude newly hired employees from plan coverage until the employees have performed at least one year of service for the employer. Thus, to the extent mobile employees fail to stay with employers for at least one year, they commonly fail to earn any pension benefit. Thus, their total working years commonly will exceed the total years of pension coverage by at least the total number of jobs.

In the Tax Reform Act of 1986 (the 1986 Act), the pension coverage rules were modified to increase the extent to which an employer's low- and middle-income employees must be provided comparable qualified plan benefits. For example, under the pre-1986 Act rules, a pension plan could qualify for tax-favored status if it covered a reasonable classification of employees. While there is always doubt whether a coverage classification is reasonable, in certain circumstances a classification including 100 percent of an employer's highly compensated employees and only 20 percent of the non-highly compensated employees could qualify as reasonable. Under the 1986 Act rules, not only must a pension plan cover at least a reasonable classification of the employer's employees, but also all of the non-highly compensated employees of the employer must receive, on average, pension benefits that are at least 70 percent of the average pension benefits received by the employer's highly compensated employees.

While gaps in pension coverage have contributed to mobile employees' portability losses, research to date has not indicated the frequency with which such gaps lead to major benefit differentials between mobile and long-term employees. Also, the extent to which the coverage changes adopted in the 1986 Act will affect portability losses is as yet uncertain as the new rules only go into effect in 1989.

DISPARITIES IN BENEFIT LEVELS

Even if a mobile employee is covered under an employer's qualified plan, portability losses for mobile workers may occur because employers do not all maintain qualified plans that provide comparable levels of benefits. For example, one employer may provide its employees with coverage under a defined contribution plan that provides an annual contribution of five percent of current compensation, while another employer maintains a 10 percent defined contribution plan or a defined benefit plan that provides a retirement benefit of 1.25 percent times years of

service times the employee's final pay. In the voluntary, employer-based private pension system, there are numerous differences in the benefit levels provided under the various types of qualified plans. Indeed, one of the premises of our voluntary pension system is that an employer should have the flexibility to set an affordable and appropriate level of benefits for its workforce.

In fact, while these disparities in benefit levels contribute to differences in benefits among employees, it is not clear that this factor per se would create a greater likelihood that a mobile employee would incur a portability loss.

DEFERRED VESTING

Even if a mobile employee earns a meaningful level of pension benefits under a qualified plan, the plan may require that the employee perform a minimum number of years of service before vesting in his benefit. Beginning in 1989, the tax law permits a plan to defer an employee's vesting in his earned benefits until he has performed at least five years of service (ten years in the case of a collectively bargained, multiemployer plan). Obviously, mobile employees will more often fail to stay with employers for the period necessary to vest in their pension benefits and thus will more frequently suffer portability losses due to deferred vesting.

In many cases, deferred vesting may also work to the disadvantage of the lower-paid employees. To the extent that low- and middle-income workers change jobs more frequently than higher-paid employees, the lower-paid mobile workers are more likely to lose accrued benefits due to inadequate vesting service, just as they are more likely not to accrue benefits due to gaps in pension coverage and lower levels of benefits.

In the 1986 Act, the pension vesting rules were modified generally to reduce the number of years of service that a plan could require an employee to complete before vesting. Before the 1986 Act, for example, a plan could defer vesting until an employee had performed ten years of service. The 1986 Act reduced the years of service that a plan could require for full vesting from ten to five years (except that multiemployer plans still may require ten years of service).

It is difficult at this time to assess fully the effect of the 1986 Act vesting changes on portability since these changes are not effective until 1989. However, it is clear that fewer employees will incur portability losses under the 1986 Act rules. While five-year vesting will still contribute to some employees' benefit losses, existing evidence does not indicate that it is a major factor in causing significant portability losses among mobile employees.

DEFERRAL OF PENSION BENEFIT ACCRUALS

Portability losses for mobile workers typically occur under those pension plans that use contribution or benefit formulas based, in whole or in part, on an employee's years of service or final pay with the employer. Under such formulas, as an employee accumulates additional years of service and approaches retirement age, the employee earns pension benefits representing increasing percentages of the employee's final pay immediately preceding retirement. Thus, by producing a pattern of deferred benefit accrual over an employee's working lifetime, these formulas provide longer service employees and employees closer to retirement with larger benefit accruals than short service, more mobile, and younger employees.

The attached Table 1 demonstrates how the value of an employee's accrued pension benefit for a year varies by age and

inflation for continuing with an employer for one additional year under a simple defined benefit plan. These results can be contrasted with a typical defined contribution plan that provides approximately the same level of accrued pension benefits for employees of all ages earning the same amount of compensation. At even zero percent inflation, a defined benefit plan provides increasing levels of benefits as age increases. Note, in particular, how the value of benefits varies enormously by inflation. In effect, when there is an unindexed plan, the combination of real wage growth and inflation erode enormously the value of accrued benefits for an employee leaving employment before normal retirement age.

This pattern of accrual has a significant effect on the benefits ultimately received by a mobile employee. For example, assume that a mobile employee earns 40 years of pension benefits with four employers (ten years with each employer) under identical defined benefit plans that base benefits on the employee's final pay with the employer. The total pension benefit earned by this employee will be significantly smaller than the total benefit earned by an employee who earns all 40 years of benefits under an identical defined benefit plan with a single employer. This is because none of the plans base their benefits on the employee's years of service with prior employers or on the employee's compensation with subsequent employers. Indeed, very few of the defined benefit plans in the private system (other than collectively bargained, multiemployer plans) grant credit for service or pay with other employers.

Service- and final-pay-based benefit formulas are most common among defined benefit plans. Indeed, even defined benefit plans with career average pay benefit formulas generally defer benefit accruals because benefits under such plans are often regularly improved or updated to reflect employees' pay as of the update. However, some defined contribution plans, such as target benefit plans and plans that allocate greater contributions to employees with additional years of service, exhibit some of the same pattern of deferred benefit accrual.

In addition to the deferred benefit accrual that naturally occurs under service- and final-pay-based benefit formulas, some defined benefit plans also permit long-service employees who retire at an early retirement age (often, age 55) to receive an additional generous pension benefit. Thus, for example, a defined benefit plan may provide that an employee who retires with at least 25 years of service at age 55 will receive the same annual benefit that he had earned for commencement at age 65. In effect, this early retirement benefit can be a very valuable, deferred benefit for employees who retire at age 55 with at least 25 years of service.

The portability effect of deferred accruals then is similar to the effect of deferred vesting. The value of the lost benefits due to deferred benefit accruals, however, is generally much greater than the value of the lost benefits attributable to an employee's first few years of service. Thus, deferred accruals may cause long-service and older employees to receive significantly greater pension benefits than the more mobile, younger employees. Also, the extent of the significant benefit differential resulting from deferred accruals is dependent on the level of inflation, and does not depend solely on real wage growth. Finally, to the extent that lower-paid workers turn over more rapidly than higher-paid employees, deferred accruals result in the lower-paid employees accruing less than comparable pension benefits than long-service employees over the same working lifetime.

PRE-RETIREMENT BENEFIT EROSION

Some commentators argue that the issue of portability involves not only differences in vested pension benefits earned

by mobile and long-term workers, but also differences in the pension benefits ultimately received at retirement. That is, portability problems can result not only from a mobile employee's failure to accrue a benefit, but also from the failure to preserve an accrued benefit as a retirement benefit.

Defined benefit plans generally may not make benefit distributions available to an employee before the employee either terminates employment with the employer or attains retirement age under the plan. Mobile workers will have more opportunities to receive pre-retirement benefit distributions than will long-term employees. Research indicates that, particularly for younger employees, high percentages of pre-retirement distributions are used for nonretirement purposes, rather than rolled over to IRA or other plans. Thus, mobile employees generally incur greater reductions in their ultimate pension benefits through pre-retirement benefit distributions. Note, however, that except for foregone tax advantages, this factor does not imply that mobile employees receive less compensation from employers, only that they consume their pension benefits earlier.

The 1986 Act adopted various rules designed to reduce the extent to which pension benefits are consumed before retirement. The Act applied a 10 percent early distribution tax, eliminated special ten-year averaging for pre-retirement lump-sum distributions, and adopted a pro rata basis recovery rule for qualified plans. These changes are likely to reduce the level of pre-retirement benefit erosion by encouraging mobile employees who do receive pre-retirement distributions to preserve their benefits in IRAs and other plans for retirement.

DISCUSSION

No matter how attractive the portability label may be, proposals intended to promote portability must be carefully evaluated in light of several important objectives: increasing savings; promoting an efficient allocation of resources; distributing fairly the significant tax benefits associated with private pension plans; and providing meaningful private pension benefits to low- and middle-income employees. As discussed above, in evaluating portability proposals, one should remember that pension benefit differentials between mobile and long-term employees may be the result of appropriate employer decisions to maintain plans providing different amounts or forms of pension benefits and appropriate employee decisions to seek employment offering different mixes of pension benefits, cash pay, and other benefits.

Features of the voluntary, employer-based, tax-qualified pension system that contribute to portability losses may also provide important benefits more consistent with the objectives set forth above. For example, it is difficult to expand coverage or improve benefit levels without also either creating disincentives for employers to maintain qualified plans by increasing employer costs or threatening the voluntary nature of the system (e.g., mandating employer-provided pensions). Also, some employers and employees may have non-tax and non-pension preferences that may justify some benefit differentials. Finally, proposals to encourage the maintenance of additional qualified plans that provide more meaningful levels of retirement benefits within the context of the voluntary system are likely either to have revenue costs or to affect adversely benefit funding or discrimination.

Benefit indexing. Those who criticize the portability effects of deferred benefit accruals often suggest indexing an employee's benefit for years between pre-retirement termination of employment and the employee's retirement age. Such indexing could be based on price or wage growth and is aimed at giving an employee credit for future pay increases with subsequent employers. However, indexing either would substantially increase

the cost of maintaining defined benefit plans or result in reductions in the ultimate pension benefits for long-service employees and employees who commence employment fewer than ten or fifteen years before retirement.

Mandating prior service credit. Another approach to addressing the portability losses of deferred benefit accruals is to mandate that defined benefit plans credit an employee's years of service with all prior employers and then to permit such plans to offset employees' pension benefits by the benefits provided by the prior employers. This approach would impose significant costs on employers that maintain defined benefit plans and thus would likely encourage employers to stop providing defined benefit plan coverage. In many ways, this approach would be impractical given the wide differences among the types of plans and could significantly deter employers from hiring older employees.

Deferred accruals may benefit mobile employees. To further complicate the analysis regarding the portability effects of deferred benefit accruals is the view that plans providing deferred accruals actually may be beneficial to mobile employees. By working the last ten or fifteen working years under a plan that defers employees' benefit accruals to the years approaching retirement age, a mobile employee is able to earn a significant portion of the pension benefits he would have earned if he had stayed with a single employer. Under the voluntary, employer-based private pension system in an economy where mobility is common, many workers will earn no or very small pension benefits for at least some of their years of employment. Indeed, during certain periods of their lives, some employees will opt for employment that maximizes their cash compensation in lieu of pension benefits. The availability of plans that defer benefit accruals to the years approaching retirement thus gives many employees the opportunity to "catch up" on earning pension benefits at the end of their working lifetimes.

Thus, one must balance the adverse portability effects of the manner in which many plans provide deferred benefit accruals with other important economic, tax, and retirement objectives. Given the ability of final pay defined benefit plans to produce a meaningful retirement benefit for an employee, including a low- or middle-income employee, over his last ten or fifteen working years, there is no single factor by which to determine when an appropriate balance has been achieved.

Other portability proposals. Other proposals have been made to address pension portability. For example, as discussed, minimum coverage and vesting requirements for qualified plans may have some effect on portability losses. Some proposals would facilitate or encourage tax-free benefit rollovers and transfers among IRAs and retirement plans (e.g., increases in the early distribution tax), while others at least would permit employees who have made after-tax employee contributions to plans to transfer such contributions to IRAs and other retirement plans. Of course, there are significant questions about the extent to which these proposals meaningfully would improve pension portability. Also, these and other proposals must be evaluated not only in light of their purported portability effects, but also in light of the important economic, tax, and retirement objectives outlined above.

CONCLUSION

Many believe that the current voluntary, employer-based pension system is flawed from a portability perspective. We recognize that, despite recent legislative changes, portability remains a very important issue that affects millions of Americans and that the current pension system could be improved to reduce portability losses.

As we have suggested, the issue of pension portability is at its core the issue of whether the existing system is "fair" as between mobile and long-term employees. Even if Congress were to come to an agreement about how fairness should be measured and to conclude that some existing plans are unfair by that measure, the preceding discussion indicates that it will be difficult to identify the policy prescription that might succeed in achieving greater fairness.

In this connection, many of the legislative proposals under consideration make important contributions to the continuing dialogue on portability. However, they must be evaluated in light of the important economic, tax, and retirement objectives previously discussed. For example, mandating greater levels of coverage or benefits for mobile workers could also result in fewer pension plans. Also, in recent years, the private retirement system has been the subject of several significant, positive legislative changes which many employers and benefit advisors have yet to fully digest. Time is needed to properly assess the portability effects of these recent changes to the pension law, many of which only become effective in 1989.

Thank you again for giving me the opportunity to present some of the Administration's views on pension portability. I would be happy to answer any questions that you might have.

TABLE 1

THE EFFECT OF INFLATION AND PLAN TYPE ON THE CHANGE in the PRESENT VALUE OF PENSION BENEFITS if the WORKER REMAINS ON THE JOB AN ADDITIONAL YEAR

Age of Employee	Years with Employer	Defined Contribution Plan	Defined Benefit Plan Inflation Rate 0%	4%	8%
25	1	$2559	$2559	$ 442	$ 84
35	10	3119	3731	1238	414
45	20	3802	5294	3019	1586
55	30	4635	7362	6843	5442
65	40	5650	10082	14826	17556

Department of the Treasury
Office of Tax Analysis

July 11, 1988

Notes: Assumes employee works for employer continuously from age 25. Initial salary [illegible]20,000, rising to $44,160 in real terms at age 65. Pension benefits are based on high salary times 2% times years of service. Real economy is assumed to grow at 2% annually. Defined contribution plan assumes 12.795% of salary contributed.

Chairman PICKLE. We thank you very much.

Let me ask either of you a question about the pending legislation. This hearing is about mobility, job mobility and pension losses, portability. But there is pending a bill that has come out of Education and Labor, the Jeffords bill—he made reference earlier.

Mr. Jeffords implies strongly that the administration favors his bill. Are either of you in a position to comment whether that bill is acceptable or whether you recommend that bill, or do you have comments about the measure that is pending?

Mr. WALKER. The administration does not have an official position on H.R. 1961. As noted earlier by some of the previous witnesses, from our perspective, Congressman Jeffords has been very involved in this area, he has tried to provide leadership, and we have provided him with a great deal of technical assistance in this regard.

The bill does take some modest first steps in this area. It deals not only with portability, but also with the issues of pension coverage and preservation. We would encourage the committee and the Congress to look at H.R. 1961 and any other legislation in light of the study results that we are about ready to release, and in light of the testimony at this hearing, to consider whether or not it is appropriate, and whether additional steps might be appropriate to deal with portability.

Mr. STEUERLE. We have also been trying to work very closely with Mr. Jeffords on his bill and have raised a number of issues that we hope will be addressed, and we don't think it is appropriate at this time to take a stance on the bill.

I mentioned one of these in my testimony, and Mr. Schulze alluded to it in a question: the issue of how we would deal with underfunded pension plans. If we require portability and allow benefits to be carried forward by employees when they left a system, this would leave a greater portion, if you will, of the underfunded liability or the risk upon the remaining employees.

These are the types of issues we want to look at closely.

Mr. WALKER. Mr. Schulze has put his finger on a very important issue. Specifically, when you have a situation with an underfunded plan, that by requiring or even by allowing in certain situations sizable lump-sum distributions, you could seriously threaten the benefit security of the remaining persons in the plan and pose additional risk to the Pension Benefit Guaranty Corporation.

Therefore, one of the things the administration feels should be considered in the context of any portability proposal is whether or not there should be restrictions on lump sums being paid when a pension plan is significantly underfunded.

This might also be appropriate to avoid a possible rush to the door by highly paid, well-informed executives who may receive their lump-sum payments in anticipation of the plan or the corporation going under.

Mr. ANTHONY. Would you yield?

Chairman PICKLE. Yes.

Mr. ANTHONY. I asked some questions about this legislation to the previous witnesses, and I have just heard your responses. What I got out of your response is that you do not, as of today, support

H.R. 1961 as the solution to the problem. In other words, you are not endorsing the bill today?

Mr. WALKER. We have not taken a formal position on the bill.

Mr. ANTHONY. And Labor does not endorse the bill today?

Mr. WALKER. That is correct. It has got some positive features. We do not have a formal position on it, and we feel that it is a modest first step and that you ought to look to see whether or not additional steps might be appropriate in that area.

It is a beginning, not an end.

Mr. ANTHONY. That would be Treasury's position?

Mr. STEUERLE. That is correct.

Chairman PICKLE. Mr. Schulze?

Mr. SCHULZE. Thank you, Mr. Chairman.

First of all, do we have knowledge from the experience of multiemployer plans with portability? How successful has it been within the multiemployer plans, or how unsuccessful has it been, and what can we learn from that?

Mr. WALKER. Generally, multiemployer plans have better portability than single-employer plans, because they typically are associated with a trade and therefore the individual will accrue pension credits, even though they might work for a number of different employers throughout their entire career.

However, as I mentioned earlier, multiemployer plans do not have shorter vesting schedules. The new 5-year vesting schedules were not extended to multiemployer plans, and we feel that is something that ought to be looked at, because unless a participant becomes entitled to a pension benefit, namely vested in a pension benefit, then portability is moot. Therefore we think as a matter of entitlement and equity, that Congress should consider extending the new 5-year vesting requirements to multiemployer plans.

Yes, they are inherently more portable provided that a participant stays within that trade throughout their entire career. But there are areas of improvement that could be achieved.

Mr. SCHULZE. What should our policy objectives be for pension portability?

Mr. STEUERLE. Mr. Schulze, I think the policy objective is really broader than just encouraging portability. The policy objective is to try to develop a good private pension system, one that is not mandatory, and one that encourages the private sector to develop a system that helps people in their retirements, and in some sense perhaps helps us as government to not always be the payer of last resort.

Mr. SCHULZE. Do you think we should nudge in that direction through tax credits or penalties rather than saying you may or may not do this or must or must not do this?

Mr. STEUERLE. That is correct. Part of the problem of setting up a particular rule as we have in the Tax Code is that years later, we find the rule isn't designed the way we want. One of the problems we noted came about because we set up a rule which operated perhaps well in a world in which we had no inflation.

When we switched to a world with a lot of inflation, we switched the mix of benefits in plans a little bit away from younger employees towards older employees. You don't necessarily want to push them back, because maybe it is not a bad idea to pay more to older

employees. But every time we fix a rule that may work well on average or at a point in time, we run the danger that it doesn't work well for someone who is not average and someone at another point in time.

I think we want to encourage the private sector as much as possible to adapt to the problems of the day. We believe that these hearings are important. We do think there are issues of portability losses. We think to a large extent that they are problems that can be solved by the private sector itself. The types of information made available at this hearing has to help plans to design appropriate policies, and that the incentives will be provided to the private sector to come up with better plans more adjusted to the needs of the day.

Mr. WALKER. I think that to the extent that the Congress is looking at the issue of portability it is important that whatever steps it takes should be designed to enhance portability within the construct of our voluntary private pension system, while avoiding some of the counterproductive consequences that Mr. Steuerle and myself discussed, such as reducing overall coverage, threatening benefit security, discouraging the hiring of older workers, et cetera.

I think in the end, it is important that we try to work through legislation and regulatory policy to remove any inappropriate barriers that might prevent people from being able to change jobs, given economic realignment and our changing economy and society.

At the same time, I think it is very important that we don't do anything that would encourage turnover, because if you encourage turnover, there are broader negative macro-economic implications which Gene probably can explain better than I, such as discouraging an employer from investing in the training and retraining of workers, which is critical for our overall competitiveness.

Mr. SCHULZE. Thank you.

Chairman PICKLE. Mr. McGrath?

Mr. MCGRATH. No questions, Mr. Chairman.

Chairman PICKLE. Let me ask a question. Listening to the witnesses this morning who have testified, it just confirms our feeling that when you go to calculate a pension or premature distribution, it is complicated. It is almost impossible to know what value to put on it at any given time.

Anybody in the Federal system who now contemplates, shifting from the old system to the new system knows this. Given that fact, would it be appropriate for us to support some kind of mandatory benefit analysis that the employer would give to the employee at a point when he may want to leave that job—would it be sensible for the Congress to say to the employer, you must call that employee and tell him he has a choice between cash, a lump sum or an IRA, whatever the choice might be so he understands what his choices are and how to fix his future pension.

That may or may not be done now. I assume most employers do it. But should we require that that be done on a one-to-one basis? Does anybody have a comment on that?

Mr. STEUERLE. I think you are raising an interesting issue and one that is certainly one we would want to look at. Obviously, as I think this hearing points out, the more information we have about

pension systems, the better we are able to understand them, and the more information employees and employers have, the better they are able to bargain to a solution to the system.

You mentioned the civil service system. The former civil service system, if you did some calculations, actually provided negative pension benefits for some young mobile employees. I think that was not obvious to these employees. I am not sure whether it needs a formal accounting or needs to be mandatory. If these results had been obvious, we would have been more reluctant to set up the system that particular way, but that particular piece of information was not widely known and the system was set up as it was.

Indeed, to give an example of how the system does adapt, we have moved to a system that puts civil servants on Social Security, so they have positive benefits in Social Security, and we have adapted additional 401(k) type of plans. So more information is certainly better.

I would not want to speak as to whether we would want to mandate particular reports. Mr. Walker could speak to the issue of the amount of reports we already require which are fairly significant.

Chairman PICKLE. Could you give me a yes or no, Mr. Walker?

Mr. WALKER. I can give you a short reply, I can't give you a yes or no. Some information must be provided under current law if a participant is receiving a lump-sum distribution. For example, the fact that they have a right to roll it over to an IRA, et cetera, and the related tax consequences.

I think it is important, as Mr. Steuerle noted, that people be able to make informed decisions when they are thinking about changing jobs in order to assess the impact of portability losses and things of that nature.

We currently are reviewing the reporting and disclosure laws in the Department of Labor right now and will consider this within the context of our review of the reporting and disclosure rules under ERISA, I do, however, think it is important to note that 85 percent of all turnover that occurs is voluntary. I think it is important that we make sure participants have adequate information to make informed choices on such matters as portability, et cetera.

While some information is currently required under law, we would look to see if that might be improved.

Chairman PICKLE. I don't know what this committee may do in that area, and that remains to be seen. That is not our purpose today. I have a feeling, though, the Congress is going to express itself more strongly than either one of you have, that information should be given to an employee. Whether it is mandatorily, required, or at what level, I am not sure. I don't see anything wrong with saying to an employee, "You have earned so much, you have got these choices", and that worker then is fully notified. He may know in general today, but there is no point in us being vague about it.

Well, I thank you very much. If we have other questions that we want to ask we will submit them to you in writing and ask you to respond to us in writing.

The next panel will be the American Association of Retired Persons, Mr. Anschutz, Dr. Emily Andrews, Ann Moss, and Donald Grubbs. This panel consists of Mr. Everett Anschutz, a member of

the National Legislative Council of the American Association of Retired Persons. I might add, he is an old and dear friend of mine and certainly one of the most respected State officials we ever had. I didn't know you were going to be here this morning, or I had forgotten, either one. We are pleased to have you here.

Another panelist is Dr. Emily Andrews, research director of the Employee Benefit Research Institute, the so-called EBRI. Then we have Ann Moss, who is director of the Women's Pension Project, Pension Rights Center; and Mr. Donald Grubbs, president, Grubbs & Co., Inc.

I am going to ask you panelists to summarize your statement because we have only an hour left, and we have another panel. So I am going to ask you to try to summarize your statement in 3 or 4 minutes so we may go onto any questions and then get the next panel since we have to be out of this room for another hearing right after lunch at 1 o'clock.

Mr. Anschutz, if you will proceed, I am personally pleased to see you here. I hope you are doing well.

STATEMENT OF EVERETT ANSCHUTZ, MEMBER, NATIONAL LEGISLATIVE COUNCIL, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. ANSCHUTZ. Mr. Chairman, I thank you very much for that kind introduction. Every month when I get my Social Security check, I say to my wife, "There is something Jake did for us lately."

My appearance here today, I feel, might be redundant because of the effective way in which you and Mr. Schulze outlined this problem and because of the extremely competent testimony we have heard so far.

I appreciate the opportunity to represent the American Association of Retired Persons to speak very briefly on this important subject. With me is Mr. David Certner, a member of the staff here in Washington.

While Social Security is and we hope will continue to be the basic floor of retirement income, we believe it is essential that we expand and increase private pension coverage, and the issue of portability is essential to that objective. It has been previously pointed out that mobility in the work force makes this a more crucial and pressing problem.

One aspect of that problem we would like to mention is that higher mobility generally is more prevalent in lower paid jobs. Our failure to provide early vesting and portability for high turnover occupations fails to deal with those people most likely in their later years to rely upon public welfare benefits to provide a survival level of living.

The new 5-year vesting provisions are certainly a step in the right direction, and some of the proposed portability bills that are currently before you take modest proper steps in the right direction.

Our study conducted by Mercer-Meidinger tends to confirm the other studies that have been detailed here. For one example, following page 15 in the written statement, we have provided you just

one of several charts which confirm and support the testimony you have previously heard. That is that multiple employment during a single career does in almost all cases result in a reduction in pension benefits.

There are two other things that reduce benefits which we think are worthy of further consideration. One is still the high number of employees, particularly in lower income brackets, who never stay one place long enough to vest and, therefore, have no benefits to be ported from one place to another. Second, we think it is far too easy for people to gain access to tax supported pension funds. That money is then expended so that by the time retirement age is reached, there is no accumulated total of pieces to form a viable pension asset.

The question was asked a few minutes ago, what would be the appropriate objective in terms of the problem before us? It is our view that the objective could be stated properly in this way. A relatively simple, properly regulated from a fiduciary standpoint fund or funds into which pieces of pension accumulations could be transferred and prudently invested; a system in which people are either discouraged or prohibited from cashing out at an early age and expending assets for which they have been given favorable tax treatment to encourage them to make some provision for their own old age. Further details on these matters are in the written statement.

So I would say, in general, we endorse the testimony previously heard, and we welcome an opportunity, Mr. Chairman, and members of the committee, to continue to work with you. This is not an issue in which I have a personal stake, but because of the future consequences of failure to act, we believe that our success in this effort will determine whether or not we have an increasing number of elderly people able to maintain some self sufficient level of survival, or whether, as the work force becomes more mobile, we may in fact create for the future an increasing percentage of elderly people who will be dependent upon a public fund.

Chairman PICKLE. Thank you very much.

[The statement of AARP follows:]

STATEMENT OF THE AMERICAN ASSOCIATION OF RETIRED PERSONS

INTRODUCTION

The American Association of Retired Persons (AARP) appreciates the opportunity to express its views and provide information on the important issue of pension portability and the retention of accumulated pension funds for retirement income purposes. AARP believes that some steps can be taken now to ensure the preservation of retirement income. However, mechanisms to make private pensions fully portable are not yet developed. AARP believes this is a need that must be addressed.

The ultimate goal of changes in the income structure serving retired Americans must be the establishment of an adequate standard of living for all older persons, including a reasonable guarantee of adequacy, stability and security of retirement income to allow individuals to plan for their retirement years. To be adequate, a retired person's income should be sufficient to prevent a significant decline in one's living standard achieved during working years. For most persons, Social Security is the foundation for retirement income. The next tier of retirement income must be the private pension, which currently enjoys substantial tax subsidies intended to foster a significant source of retirement income for large numbers of retirees.

Social Security will continue to be the most important source of retirement for many years to come. However, the need to expand and strengthen the private pension system is clear both for those now approaching retirement and for the enormous post-war baby-boom generation, which will begin to retire in the year 2010, less than 25 years from now.

The Tax Reform Act of 1986 included important provisions to improve the private pension system to ensure that, over time, it will become a more significant source of retirement income. The Act's provisions to expand coverage, lower minimum vesting standards, reduce integration, and impose tax penalties on early withdrawals from pension plans are substantial improvements over previous law. While these changes will significantly improve the private pension system, not all areas of need in the private pension system have been addressed.

PENSION PORTABILITY - DESCRIPTION

Neither the Employee Retirement Income Security Act (ERISA) nor the Tax Reform Act of 1986 addressed the issue of pension portability. Portability refers to devices that can be used to preserve pension benefit value that might otherwise diminish due to an employee changing jobs or changing retirement plans.

While there are no simple solutions to the portability questions, a number of options exist. This statement will discuss some of these options, and a number of the relevant issues that must be considered. Also, this statement will introduce some findings from an AARP sponsored study of portability.
Various definitions of portability -- describing different degrees and types of protection for benefit rights --have developed. "Portability of service" is the most sweeping definition of portability, encompassing retention of all rights which the employee had with the first employer. Portability of service allows the employee to add service from two or more employers in the calculation of the benefit. Such portability is commonly offered through multi-employer pension plans, and in special situations, such as through the Teacher Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF). Of course, Social Security is the best example of a completely portable system. In essence, under these systems, the employee retains the rights which he/she would have had if no change in employment had taken place.

Two other types of portability, "portability of value" and "portability of benefits", involve different bases of

calculation. In both, a benefit is determined when service is completed with the first employer, and that benefit is independent of any benefit earned later. In the case of portability of value, the benefit earned prior to changing jobs is calculated as a lump sum. This "value" is paid out to the employee, who can either spend the money or deposit it in another retirement vehicle (called a "rollover"). If there is portability of benefits, the benefit is determined and retained in the original employer's plan. It remains in the plan until it is paid out as a retirement benefit, generally in the form of a regular monthly payment. (A brief overview of the characteristics of each type of portability is summarized in Exhibit 1.)

PORTABILITY - WHY IT IS NEEDED

Our nation has an extremely mobile workforce, making portability a much needed piece of our pension system. While mobility is commonly associated with younger workers, it is also prevalent among middle-aged and older workers. Of full-time male workers entering a job at age 25, 67 percent will leave before 10 years; for those entering at age 45, 53 percent will not stay 10 years. In 1983, 45 percent of men and 66 percent of women had less than 10 years of service at their current jobs. The average years of service at one job is 5.1 for men and 3.7 for women.

Because of the high mobility of today's workforce, the likelihood of an employee remaining with one employer and in one plan has greatly diminished. Workers who do manage to stay with one employer can benefit from the full income replacement designed in the pension plan. Those who change jobs often are now likely to receive a much lower replacement of income from the combined plans.

The loss of benefits in job change is due to a number of factors. Workers can lose pension benefits because of non-vesting, periods out of the work force, periods of part-time work, loss of pre-retirement inflation protection, pre-retirement consumption of the retirement benefit (e.g. spending lump sum pay outs), and plan terminations. In the case of plan terminations, the worker can lose pension benefits without changing jobs, since it is the employer who chooses to end the plan. (For example, in this decade, there has been a trend towards termination of healthy pension plans by the employer simply to recapture plan funds.)

"Vesting" is one of the first keys to portability, since an employee must first achieve the ownership of the pension benefit that vesting confers. The Tax Reform Act of 1986, by generally lowering the vesting period from ten year cliff vesting to five year cliff vesting (beginning January 1, 1989), has significantly improved the opportunity to "earn" a pension at any given job, particularly for employees who change jobs several times throughout their careers. However, along with this improved opportunity to earn a pension at any given job, comes the related question of how this earned pension will add-up towards retirement. An individual facing a work career that includes a number of vested pensions earned through different employers needs a mechanism to ensure that these pension amounts will be there to provide for an adequate retirement income.

The absence of a way to aggregate accumulated funds means that small amounts of vested benefits may be "cashed out" in lump sums before retirement. Recent studies have indicated that only a small percentage of current lump sum recipients currently retain the money for retirement income purposes. Nearly 70 percent of lump sum recipients simply spend the money. Improvements such as five-year vesting will not significantly improve retirement income security for future retirees unless accumulated pension funds are retained for the purpose for which they were intended.

EXHIBIT I
BASIC CONCEPTS OF PORTABILITY

Concepts	Type of Portability		
	Service	Value	Benefits
Basic operation	Service credits transfer when employment changes	Benefit earned paid out or rolled over	Benefit value is retained in the form of a benefit payable at retirement
Types of portability has been commonly applied in	Social Security Multi-employer plans Controlled groups	Defined contribution plans or lump sum payouts under defined benefit plans	Defined benefit plan provisions for deferred vested benefits
Inflation protection before retirement	Yes, (for defined benefits), if final average plan or amendments provide this (or indexing like Social Security); not under defined contribution plan unless investment returns are adequate to provide this protection (unlikely)	No, unless investment returns are adequate to provide such protection (unlikely)	No
Employee protection of benefits against loss due to job change	Complete, if new job is within group of employers allowing portability of service	Partial; pre-retirement inflation protection is lost	Partial; pre-retirement inflation protection is lost
Risk that employee will spend retirement savings for non-retirement purposes	No, payout not permitted	Yes, unless rollover takes place	No, unless paid out as a single sum
Cost related to period of service depends on future pay	Yes, in final pay plans, or as a result of amendments to career average pay plans	No	No
Cost related to period of service depends on choice of retirement age and future mortality	Yes	No	Yes
Mechanics	Requires all employers to be in same plan, or benefit payment is split between plans, or assets and liabilities are transferred new employer	Plan pays out benefit at termination and value is transferred to IRA or other employer plan (or spent currently)	Plan retains vested benefit at termination and pays out at later retirement Plan must report vested benefit on IRS Schedule SSA, and individual is notified of benefit by Social Security
Former employer retains obligation to pay PBGC premiums	Obligation is with plan, and shared by all employers if in same plan; yes, if benefit payment is split between plans; no, if transferred	No	Yes

TYPES OF PORTABILITY - FACTORS

Portability of service: Portability of service encompasses broad coverage of retirement security, and its application creates equally broad questions which must be resolved. For example, plans considering portability of service must consider:

- Differences in benefit formulas among plans;
- Differences in vesting periods among plans;
- Responsibility for service prior to job change when an employee is hired within the portability group;
- Responsibility for benefit payment to be split among the various plans or whether assets and liabilities need to be transferred; and
- Financial responsibility for benefits earned in a final pay formula on account of service in one plan and pay increases in another plan.

In general, while portability of service can provide important pre-retirement inflation protection, significant differences in benefit formulas among plans make portability of service without some limitations or confinement to a particular employer group very complex. Issues of employer cost sharing become difficult to work out, even if one assumes equal employee movement among employers. Employers would be reluctant to expand participation in such plans, given that pension obligations are somewhat unpredictable, withdrawal liabilities can be large, and employers will have reduced control over their plans.

Portability of benefits and portability of value: Assuming full vesting, an employee's benefits may still be required to remain in the plan until these benefits become payable at normal or early retirement age. The result of portability of benefits is that an employee with a series of employers with pension plans would collect retirement income from a number of different sources.

The transfer of value of these plan benefits would allow the employee to receive the value of the benefits accrued at job change, thus having the benefit "rolled over" into the new employer's plan. In theory, this element of portability of value would allow the employee to accumulate benefits from employer to employer, so that benefits payable from the final employer's plan would represent the total benefits accumulated throughout the employee's career.

Permitting transfer of value, as with leaving benefits in a plan, can result in loss of benefit value as a result of inflation. In addition, for those employers that offer ad hoc increases to retirees, employees who choose to transfer value would not benefit. For defined contribution plans, investment return will determine whether benefits were better left behind, assuming the funds are not spent.

Portability of value as an alternative to portability of benefits has both pros and cons for employers and employees. For the employee, some of the advantages of portability of value are:

- increased flexibility in use of the money;
- avoidance of the inconvenience of small benefits paid by several employers; and
- access to funds previously held in defined benefit plans.

Disadvantages to the employee are:

- the risk that the money will be spent for non-retirement purposes;
- possible loss of Pension Benefit Guarantee Insurance for some funds; and
- possible loss of a survivor annuity for a married employee.

One variable that will be either positive or negative is the

uncertainty of investment return.

From the employer's point of view, transfer of value includes the advantages of:

- o less recordkeeping; and
- o lower PBGC premiums.

Employer disadvantages include:

- o loss of assets and investment base from the pension fund; and
- o frustration of the original intent of the plan - retirement security - if the employee exercises his option for immediate consumption of the benefit.

PORTABILITY - SCENARIO ANALYSIS

While a number of portability issues have already been raised, AARP is committed to an understanding of the practical effect of implementing any number of different portability scenarios. Towards this end, AARP contracted with Mercer-Meidinger-Hansen to study the need for pension portability to preserve benefits for those who change jobs and/or move in and out of the work force.

The study attempts to show, through various scenarios, the importance of portability in preserving pension benefit value. The study used financial modeling techniques to examine the difference in pension benefits for hypothetical workers with a variety of career patterns. The six scenarios chosen varied with regard to:

- o initial entry age into the work force;
- o the age when work stops;
- o the age when benefit payments begin;
- o the number of years spent out of the work force;
- o the incidence of part time work;
- o the benefit plan assumed; and
- o the vesting period of the benefits.

Each scenario was modeled assuming several plan mix variables including different benefit plan types and vesting periods. Each scenario and its variations were compared with retirement income assuming a single job career pattern, to highlight the pension benefit losses that persons with multiple job careers often face. Additionally, the analysis is able to examine the effect of a worker moving from a defined benefit to a defined contribution plan and vice versa.

The following scenarios were modeled:

Scenario	Age at entry	Age work stops	Age pension starts	Years out of workforce	Part time work	Number of jobs
I	25	65	65	2	None	3
II	21	67	67	0	None	7
III	19	58	62	6	None	8
IV	21	62	62	6	Yes	3
V	26	65	65	3	Yes	6
VI	46	65	65	20	None	4

For the purpose of illustrating how persons with several jobs experience pension benefit losses, two of the above scenarios will be discussed in further detail.

Example: Scenario II

Scenario II envisions an employee who is employed continuously from age 21 to age 67, always covered by a pension plan, but whose first three jobs last five years each. The employee's longest job is next at eight years and then jobs last seven, six and five years respectively. This scenario is typical of either a male or female who is never out of the workforce, but has a series of jobs.

Scenario II assumes defined benefit plan coverage. Similar career patterns are used with three different pay levels, and a defined benefit plan with integration and one without integration. In total, the six versions of Scenario II explore the effect of multiple jobs on total benefits.

Results: Scenario II
The effect of multiple jobs on total benefits from defined benefit plans is dramatic. In every case, and at all salary levels for both integrated and non-integrated plans, benefits are greater in the one employer version of the scenario. (See Exhibit XII in the Appendix, which illustrates the annual income amounts and single sum values at age 67 for all versions of Scenario II.) The one-employer benefits under the deferred payment option exceed the multiple job benefits at each salary level by 56 percent.

This dramatic reduction occurs because benefits in defined benefit plans are frozen when the employee separates, losing pre-retirement inflation protection. The benefits are set, once and for all, at the level accrued at termination of employment. Subsequent salary increases serve to increase future benefits only. Past, frozen benefits do not enjoy the increases associated with higher levels of future earnings. Even though the worker moves from one final average pay plan to another, the worker accumulates frozen benefits that do not reflect true final earnings at age 67. The result is a depleted level of benefits at retirement.

For a specific example, under Scenario II, the study illustrates how a 67 year old retiree with a salary at hire of $16,000 will fare under defined benefit plan coverage under one job or multiple jobs. The difference in the lump sum value of retirement income at age 67 for this retiree is over $20,000, resulting in a 36 percent reduction in value for the retiree with multiple jobs. (See Chart A and accompanying graph on page 15.)

Example: Scenario III
Scenario III assumes an employee in the workforce from age 19 through 23 with pension coverage. This employee then drops out of the workforce from ages 24 to 26, reenters part time from ages 27 to 28 with no pension coverage and then has five full time jobs ranging from 1 to 6 years covered by a pension plan. The final sixth job lasts nine years and is covered by a pension plan. The employee ceases employment at age 58 and commences receipt of pension benefits at age 62. Such a scenario might be typical of a woman who enters the workforce after high school, leaves to have children, is employed part time while they are young and full time once they are older. She may retire early with her husband or to care for an elderly dependent.

Results: Scenario III
The benefits available after a career of coverage in a series of defined benefit plans with five year vesting are 43% of those provided in the one employer situation. The defined contribution pattern, on the one hand, provides 62% of the benefits available under the one employer career. This contrast arises from the fact a major forfeiture of benefits occur late in the career, and because no retirement plan coverage is available at the very end of the career. Since the defined benefit plan benefits are more valuable at these career points, the forfeitures of benefits and the loss of coverage at the older age has a greater effect on the ultimate level of retirement income than under the defined contribution plan. (See Exhibit XVIII in the Appendix which illustrates the annual income amounts and single sum values at age 62 for all versions of Scenario III)

This scenario illustrates the dramatic impact of investment return after rollover. If the worker elects to cashout benefits at each job change and rolls their value into an IRA, the

retirement benefits will vary from those provided through the original pension plan as the investment return in the rollover vehicle varies. Workers benefit from rolling over funds from defined benefit plans to IRA's when the rollover interest rate is great enough to overcome the actuarial mortality discounts applied in the defined benefit plan retirement calculation.

The defined contribution coverage pattern provides a more straightforward insight into the effects of rollovers on retirement income levels. If the original plan and the rollover vehicles accumulate funds at the same rate of return, then the retirement income is the same whether payments are deferred or rolled over. The effects of higher returns in the rollover vehicle than in the original plan is even more pronounced in a career with defined contribution plan coverage than that with defined benefit coverage. This results because job changes are occuring at young ages and benefit values are all rolled over to a vehicle with a high rate of return. The result is much higher levels of income at retirement.

For a particular example, this scenario illustrates the effect on an age 62 retiree, at a salary of $16,000 at age of hire, of one job versus multiple jobs, under both defined benefit and defined contribution plan assumptions. The reduction in value with multiple jobs in a defined benefit plan assumption is over $20,000, a reduction of 57 percent. The reduction under a defined contribution plan is over $25,000, a 38 percent loss. (See Chart A and accompanying graphs.)

CHART A*
(with accompanying graphs)

PENSION PLAN BENEFIT MODELING
LUMP SUM VALUE (1987 $) OF
RETIREMENT INCOME

	Retirement Age	Salary at Hire	One Job	vs. Multiple Jobs	Percent Change
Scenario II (Defined benefit) (Graph A-1)	67	$16,000	$62,917	$40,280	-36%
Scenario III (Defined benefit) (Graph A-2)	62	$16,000	$38,421	$16,611	-57%
Scenario III (Defined contribution) (Graph A-2)	62	$16,000	$65,370	$40,292	-38%

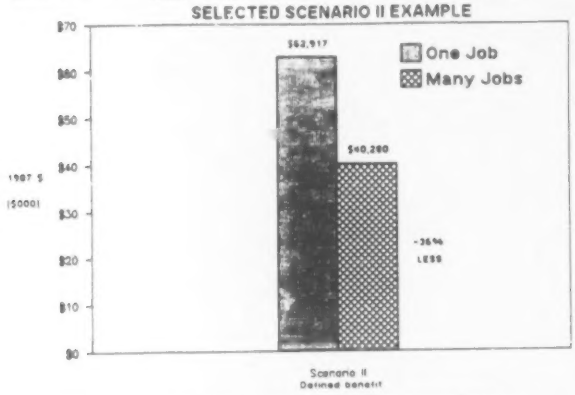
* Reference to Appendix A

Scenario II: (Defined Benefit)
Exhibit XII, Deferred Payments II.1 and II.7

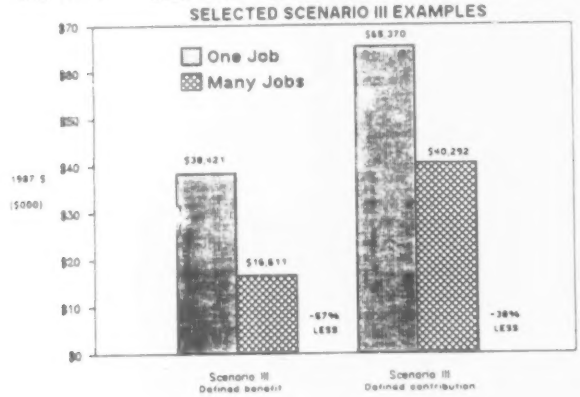
Scenario III: (Defined Benefit)
Exhibit XVIII, Deferred Payments III.1 and III.9

Scenario III: (Defined Contribution)
Exhibit XVIII, Deferred Payments III.2 and III.10

GRAPH A-1 LUMP SUM VALUE OF RETIREMENT INCOME
SELECTED SCENARIO II EXAMPLE



GRAPH A-2 LUMP SUM VALUE OF RETIREMENT INCOME
SELECTED SCENARIO III EXAMPLES



SCENARIO ANALYSIS - SUMMARY OF FINDINGS

In addition to some of the specific findings previously mentioned, the analysis permits the following generalizations based on the data:

o There are major, quantifiable differences in retirement benefits received by those who have a one job career and those with a multi-job career.

o Benefits under different types of formulas are earned at different rates over an employee's career. Most defined contribution plan formulas provide for rapid benefit accrual at young ages (since contributions have a long period of time to grow before they are paid as retirement benefits), whereas most defined benefit plan formulas provide for lower benefit accrual in the early years of service.

o The extent of the retirement benefits lost as a result of a change in employment depends on the nature of the plan, the provisions for pre-retirement inflation protection, and the requirements for vesting of benefits.

o Other studies show that employees shift jobs frequently and frequently spend early lump sum distribution of retirement benefits when received rather than saving them. This analysis shows that the resulting non-vested terminations and lump sum consumption cause significant retirement benefit loss.

o Some of the largest losses arising from changes in employment are from defined benefit plans which offer pre-retirement inflation protection, because that protection is lost.

o Employees with defined benefit plan coverage often lose benefits when moving from one job to another. These losses are due to loss of benefits which were not vested, gaps in coverage, and loss of pre-retirement inflation protection on benefits already earned.

o Employees with defined contribution plan coverage are much less likely to lose benefits when moving from one job to another. Losses which do occur are due to loss of benefits which were not vested and gaps in coverage.

o Workers who are absent from the workforce for temporary periods or who work part time lose significant amounts of pension income in most cases. Other studies have shown such career patterns are common to women; therefore, women can be heavily affected by such benefit losses.

RETENTION OF PENSION FUNDS FOR RETIREMENT - LUMP SUM TREATMENT

The analysis shows that the consumption of lump sum benefits plays a significant role in determining retirement benefit loss. Because studies have consistently indicated that lump sums have tended to be spent, not saved for retirement, this problem merits particular consideration. Public policy should encourage the retention of lump sums for retirement income purposes.

In order to retain lump sums in the retirement income stream, the law should require that, to the extent employers provide lump sums, these sums must be distributed to a retirement income vehicle, not the individual. While current law allows for a rollover to an IRA, or to a new employer's plan, such treatment is not mandated. While other retirement vehicles (e.g. "portable pension plans") may also be needed, the important step is to prevent the lump sum from going directly into the hands of the individual. Although the individual may inevitably gain access to any retirement funds from the retirement vehicle, it is more likely that the individual will leave the money for retirement if it is placed directly into a retirement vehicle. To further restrict access to funds before retirement, Congress should also consider restrictive measures such as higher tax penalties for early distributions. Limits as to the circumstances for early withdrawals, and restrictive forms of benefit distribution (e.g. life annuity), would also serve to maintain funds for retirement income purposes.

CONCLUSION

While comprehensive portability devices may still be a long way off, there are intermediate steps that can be taken to improve current retirement income practices. For example, policies encouraging the retention of pension funds for retirement purposes, particularly lump sum distributions, should be a high priority. We must continue efforts to preserve and enhance retirement income for future retirees, while the larger question of pension portability is addressed.

AARP looks forward to working with this Committee to help improve the retirement security of current and future older persons. The Association hopes that information, such as that provided in the analysis discussed above, will promote better understanding of both the problems and the necessary solutions.

Along with better understanding of what the law should provide, however, comes the related issue of what employees need to know about their retirement. Recent studies suggest that a major lack of awareness exists among employees regarding employee benefits. Increasing employee education and awareness about such benefits and their impact on retirement must become a priority if employees are to make informed decisions regarding portability and the use of pension funds pre-retirement. Any policy decisions regarding portability should include greater employee education on retirement income issues.

APPENDIX A

The following two tables are from the draft Marcer-Meidinger-Hansen "Pension Portability Analysis" report prepared for AARP. The tables summarize the total amounts of retirement income for employees in several variations of Scenarios II and III. Each scenario was simulated with a different "plan mix" and/or annual earnings amount. The variables under "plan mix" included:

DB - Service under a non-integrated defined benefit plan;
DB-I - Service under an integrated defined benefit plan;
DC - Service under a defined contribution plan;
One Employer - Service takes place under one employer.

Vesting assumptions (3-year or 5-year) and investment returns (from 5.5% to 9.5%) for defined benefit and defined contribution plans are stated.

The amount of retirement income available at retirement was measured in two ways, as an annual annuity and as a lump sum, both expressed in 1987 dollars. Three patterns of retirement income distributional patterns were simulated including:

Deferred Payments: The value of vested benefits are held in the plan until retirement.

Cashout and Spend: The value of vested benefits are cashed out and spent by the employee.

Cashout and Rollover: The value of vested benefits are cashed out and rolled over to another retirement vehicle.

Chairman PICKLE. Dr. Andrews.

STATEMENT OF EMILY S. ANDREWS, PH.D., RESEARCH DIRECTOR, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Ms. ANDREWS. Good morning, and thank you.

First let me mention the Employee Benefit Research Institute is a nonprofit public policy research organization. We attempt to provide information that can be used for the formation of public policy. We do not, however, take positions on public policy issues.

I have submitted written testimony to the subcommittee and will summarize the major points of that testimony now.

This testimony focuses on issues that relate to enhancing the portability of cash distributions. Cash distributions are portable when directly transferred to the employee leaving the sponsoring company or transferred directly to another retirement arrangement.

The Pension Portability Act—H.R. 1961—seeks to increase coverage and improve system portability and benefit preservation by discouraging preretirement cashouts and encouraging the use of annuity provisions.

Defined contribution plans, which often provide cash distributions upon job change, have become more prevalent in recent years. The share of defined contribution plans increased from 66 percent of all plans in 1976 to 71.4 percent in 1986. Defined contribution plans also hold an increasing share of the assets held in private trusteed pension funds. In the first quarter of 1988 they held $410 billion of assets, or 34.4 percent of trusteed funds.

Benefits are more likely to be dissipated if workers change jobs. American workers tend to hold 10 or 11 jobs over a lifetime and so change jobs frequently during certain periods of their lives. Recent declines in job tenure, however, are not due to greater labor market instability, but are a result of changes in the distribution of workers by age and sex.

Survey findings show that close to 85 percent of all pre-retirement distributions received by workers who changed jobs were for amounts of less than $5,000. Only 26 percent of persons receiving preretirement distributions for less than $5,000 saved some of their cash-out.

A simulation model was developed by EBRI to provide examples of the economic consequences of job change on pension entitlement. If a hypothetical employee receives inflation-indexed distributions of exactly $3,500 at each of three job changes, the total value of these cashouts would be $21,000. This would represent a substantial share of retirement benefits for some employees.

Lump-sum distributions at retirement are already quite common. Among workers retiring in 1982, nearly 10 percent of all men with pension coverage on their last job reported receiving a lump-sum distribution. The median value of that distribution was $20,000.

The aim of pension policy is delivery of benefits. Using simulation techniques, we have shown the baby boom can expect higher levels of retirement income than current retirees. But the total pension replacement rate in retirement—the ratio of pension and Social Security benefits to preretirement earnings—will fall from

49 to 45 percent by the time the baby boom retires. If portability legislation were enacted, replacement rates could be higher.

There are tradeoffs between different portability proposals, however. On the one hand, voluntary incentives may not work. On the other hand, mandatory rollovers would preserve benefits, but workers would lose the flexibility to use their funds for other purposes. As a consequence, a key public policy consideration may be the way in which lump-sum payments ought to be integrated into the future structure of the retirement and health care systems.

My written testimony provides more indepth information about these issues. I would be happy to answer any questions you might have about these findings or any other aspects of portability and preservation.

Thank you for providing the opportunity to appear before the subcommittee today.

Chairman PICKLE. I thank you, Dr. Andrews.

[The statement of Emily Andrews follows:]

PORTABILITY, PRESERVATION AND THE RETIREMENT INCOME SYSTEM

Statement of
Emily S. Andrews, Ph.D
Research Director
Employee Benefit Research Institute

What is Portability?

Portability involves the transfer of pension benefits from one pension plan to another. If all employees spend their entire careers working for only one employer, portability would not be an issue. All pensions would be based on full-career service. Similarly, if pensions were only paid through Social Security or some other nationwide plan, benefits would be fully portable between jobs, and all years of service would be credited by the plan. In our society, most employees change jobs and many employers supplement their employees' Social Security benefits through employer-sponsored plans.

In a pension system characterized by a diversity of benefits tailor-made to the specific industry, the company, and the work force, automatic pension credit transfers are difficult to attain. One employer may have a defined contribution plan and the other a defined benefit plan. Benefit and retirement provisions may vary considerably among plans, and plan contribution rates may differ as well.

The benefits of diversity in pension provisions include retirement practices that directly enhance the productivity of the company and that are appropriate to the financial status of the firm. In addition, differences in pension plan provisions can better meet the needs of different workers for their own retirement income. The cost of this diversity, however, is the relative benefit loss that may take place for employees who switch plans.

While the basic concept of a fully portable pension is easy to understand, it is considerably more complex to categorize the ways in which our diversified system fails to meet full portability. To do so, the components of portability can be described in terms of: (1) vesting; (2) credited service; and (3) accrued current values (cash distributions).

Vesting

Benefit portability is enhanced when vesting schedules are shorter. Employees who leave company plans without meeting vesting standards forfeit all benefits that would have been earned had they stayed on the job. Employees changing jobs after meeting vesting standards are entitled to unforfeitable pension rights. The 1986 Tax Reform Act (TRA) radically changed vesting standards for employees covered by single-employer, private-sector, defined benefit plans. Such changes, effective in plans years beginning after December 31, 1988 will essentially reduce the earlier Employee Retirement Income Security Act's (ERISA) 10-year vesting standard to a 5-year vesting provision. Five-year vesting will affect both defined benefit and defined contribution plans, although defined contribution plans typically had shorter vesting schedules even prior to TRA. Projections indicate that because of 5-year vesting, over 70 percent of the baby-boom cohort will have pension income at retirement from employer-sponsored pension plans.

Credit Portability

A second type of portability is that of credited service. When credited service is portable, years of service credited to one plan are maintained even upon job change. For instance, even if the employee has not met the vesting standard, years of participation would be carried over into the next employer's plan and would count toward the employee's pension on the next job. Multiemployer pension plans are often used to illustrate service portability. In this case, employees may change jobs among a number of participating employers and continue to credit their service to their pension. With defined benefit plans, when credited service is not portable across employers, vested benefits are frozen when employees change jobs before retirement. Furthermore, nonvested years of participation yield no future benefits at all.

The problems inherent in proposing a system of service-credit portability, however, are evident in the situation of the former Bell System. After divestiture, the Deficit Reduction Act of 1984 required that service credits be recognized for employees moving among companies of the former Bell system. The 11 former Bell companies affected codified their obligations to their employees (as of December 31, 1983) in a document known as the Mandatory Portability Agreement. It took nearly one year for the companies to resolve most of the major issues related to crediting service and transferring assets. Since the agreement, concerns have been raised about recognition of prior service, retiree medical coverage and the assumption of unfunded liabilities. Furthermore, administration is reported to be costly and time-consuming. Recognition of so many problems in a favorable situation may have tempered active legislative interest in this area.

Portability of Values

Portability of accrued current values (cash distributions) refers to the cash value of vested benefits. Distributions are portable when directly transferred to the employee leaving the sponsoring company or transferred directly to another retirement arrangement. The first situation is by far the most common.

Cash distributions are most often associated with distributions from defined contribution plans but may apply to certain defined benefit plans as well. Most defined contribution plans distribute vested benefits in the form of a cash lump-sum distribution, or "cash out" upon job change and at retirement. If preretirement cash outs are invested, the funds will continue to earn a market return until retirement, which, on average, would be roughly equivalent to what the employee would have received from the plan at retirement. A loss in retirement benefits occurs if the distribution from the plan is used for current expenditures rather than being saved and invested. This portability loss has been the focus of recent congressional interest. This testimony focuses on issues that relate to enhancing the portability of accrued current values.

The Issues Being Addressed?

Three bills introduced in Congress in 1987 are intended to improve pension portability. The first, the Pension Portability Act (H.R. 1962 and S. 944) seeks to increase coverage and improve portability through a new type of retirement plan and through changes in Simplified Employee Pensions (SEPs). It also seeks to use pension rollovers to improve system portability and benefit preservation. The proposal was, in part, a reintroduction of the 1985 Retirement U.S.A. proposal. The pension portability act was also reintroduced in 1988 (H.R.1961). The second bill, the Portable Pension Plan Act (H.R. 1992) seeks to encourage pension

portability, preserve benefits, improve SEPs and help small employers. The third bill, the Pension Portability Improvement Act (H.R. 2643 and S.1349) also seeks to improve pension portability, preserve benefits and encourage SEPs. All three bills have similar concerns. Each seeks to ensure that lump-sum distributions are saved until retirement. And each seeks to ensure that assets held until retirement are used for retirement income.

Portability of Values

Just as recent portability proposals seek to preserve preretirement distributions for retirement, the 1986 Tax Reform Act sought to achieve this goal by imposing a 10-percent penalty tax on lump-sum distributions that were not rolled over into an IRA. It is too early to determine the extent to which this additional tax has achieved that goal. The three current portability proposals differ in the extent to which they would keep the decision to rollover funds in the hands of the employee.

The Portable Pension Plan Act requires employers to make direct transfers to portability maintenance accounts, such as defined contribution plans or IRAs. Defined contribution plans do not have to accept distributions from other plans, however. Defined contribution plans must offer transfers upon job termination but defined benefit plans need not. The bill makes it more difficult for employees to directly receive and spend their preretirement distributions. Only SEPs and IRAs would be allowed to make direct participant transfers. Furthermore, the penalty tax on preretirement cashouts would be increased from 10 to 20 percent as a further incentive to preserve early pension distributions until retirement. The Pension Portability Improvements Act takes these provisions one step further. Distributions would not be permitted from any pension plan before retirement except in the form of an annuity. In other words, distributions would not be available before retirement.

The Portable Pension Plan Act, which would continue to allow preretirement lump-sum distributions if the penalty tax were paid, requires defined contribution plans to accept rollovers from other plans. By contrast, the Portable Pension Plan Act requires the U.S. General Accounting Office to study ways for defined contribution plans to accept rollovers.

Preservation

A second concern is to ensure that retirement benefits are available for retirement income. Just as preretirement distributions may be spent for current consumption at retirement, lump-sum retirement distributions may be spent early in retirement reducing retirement income in later vulnerable years. This concern dovetails with other equity issues related to spousal benefits. The Retirement Equity Act of 1984 expanded ERISA by requiring that spouses explicitly sign-off on benefit distributions made in other than the joint and survivor form. (ERISA made the joint and survivor annuity the normal option for married couples.) Concern about the form of distribution was motivated by evidence that widows usually have significantly lower income than married couples. Recent concerns are, in part, motivated by the knowledge that older retirees often have lower income than recent retirees.

Under the Pension Portability Act, joint and survivor distributions would be required for SEPs and portable pension plans. Annuity payments would be provided unless specifically waived by the participant and the participant's spouse. Under the Portable Pension Plan Act, the normal benefit option would be a stream of payments for life unless another form of distribution were requested by both spouses. Under the Pension

Portability Improvements Act. distributions would not be permitted from any pension plan except as a lifetime annuity (or equivalent stream of payments)

Jobs and Job Tenure

The need for portability and preservation legislation is integrally related to the way the labor market functions. Benefits are more likely to be dissipated if workers change jobs many times over a career. American workers exhibit many patterns of lifetime labor force participation. Some individuals have held their job with the same company for their entire lifetime; in the future, others will to do the same. But many workers have many jobs. Women have more irregular careers than men and have shorter job tenure. Nevertheless, certain overall career patterns have important implications for portability.

Lifetime Employment

The reason many employees can expect to receive lump-sum distributions from prior jobs is because relatively few workers have lifetime employment. Many younger workers use their early years on the job for experimentation, changing jobs before they find a career that is, hopefully, both interesting and financially rewarding. Other workers make job changes later on to take advantage of new opportunities. And, of course, some individuals become unemployed or decide to leave the labor force for personal reasons. In a seminal study, Robert Hall used Census data to show that both men and women typically hold 10 or 11 jobs over a lifetime. By age 24, the average worker will have held the first 4 jobs out of a total of 10. The next 15 years will contribute another 4 jobs. Consequently most employees will not have vested in their plans during their early work years.

This hypothesis is reinforced by data on the proportions of wage and salary workers with 5 years or more on the job -- a rough proxy for vesting standards after tax reform. Only 7.3 percent of workers under age 25 had 5 or more years of tenure in 1983. This figure increased to 37 percent of those age 25 to 35 and continued increasing gradually so that over 75 percent of all nonfarm workers age 55 to 59 ended up with 5 or more years on the job. These figures demonstrate why many workers can count on pension benefits at retirement. They also suggest that many workers will accumulate pensions from more than one job. The issue is whether these benefits will be maintained until retirement.

Trends in Job Tenure

Some are interested in augmenting pension portability because of the perception that workers now change jobs more frequently than they used to. U.S. Census Bureau data do indicate that the average job tenure of working men fell between 1963 and 1987 from 5.7 years to 5.0 years. But almost all of this decline was a result of the changing age distribution of the work force. Among prime-age working men age 25 to 34, job tenure increased from 3.5 years in 1963 to 3.7 years in 1987. Tenure for men 35-44 averaged 7.6 years in both years. Men age 45 to 54 averaged 11.4 years on the job in 1963 and 12.3 years in 1987. Job tenure for women increased overall with gains particularly noticeable among women 35 years of age and older. Thus, observed declines in job tenure are entirely a result of changes in the distribution of workers by age and sex. Women have shorter tenure than men and younger workers have shorter tenure than older workers. In view of this evidence, portability may be of increasing concern due to changes in plan provision and societal expectations about retirement income but not because job stability has, on

average, declined. Nonetheless, some, such as Pat Choat, suggest that changes taking place in the economy will require more flexible employment relationships in the future to maintain competitiveness. These arguments would predict that job tenure will be shorter in the future.

What Plans Are Provided?

Neither career patterns nor the provision of benefits operate within a static environment. Portability and preservation issues become more important as lump-sum distributions become more prevalent and are called upon to provide a greater fraction of retirement income. An expansion in the role of lump-sum distributions can stem from the greater prevalence of defined contribution plans and from greater asset accumulation within those plans. Lump-sum distributions could become a more common option in defined benefit plans. For the moment, the expansion of defined contribution plans seems the more significant trend.

More Defined Contribution Plans

The number of defined contribution plans has grown since 1974 from an estimated 245,000 in 1974 to 606,000 in 1986. Over 70 percent of all plans are defined contribution plans. Defined benefit plans actually account for the majority of plan participants, however, since many defined contribution plans are pension and profit sharing plans sponsored by small employers,. Moreover, many participants in defined contribution plans also are in defined benefit plans.

The proportion of defined contribution plans has increased since the enactment of ERISA but not necessarily as a direct result of that legislation. Many believed that ERISA's changes -- including minimum funding standards and mandated insurance for defined benefit plans -- would result in a significant decrease in the number of defined benefit plans. Contrary to expectations, the absolute number of defined benefit plans has grown every year (expect 1976 and 1984). According to EBRI's plan-count statistics, defined benefit plans grew at an average annual rate of 5.6 percent between 1976 and 1986. But, as a proportion of all plans, the share of defined benefit plans fell 5.4 percentage points over the same period from 34.0 percent to 28.6 percent of all plans.

While the shift towards defined benefit plans has not been consistent in every year, other evidence suggests that it represents a long-run trend. Many employers have added defined contribution plans as secondary plans, and many employers are now restructuring their benefits to prepare for the baby boom's retirement. Employers have found that younger workers of baby boom age react favorably to defined contribution plans because they can see an immediate current cash value. In addition, employers realize that defined contribution plans are no longer simply an extra emolument. The benefit buildups are too great and the baby boom's retirement is too costly. Thus, defined contribution plans are becoming an integral part of retirement income planning. To the extent that cash distributions from these plans are spent before retirement, retirement benefits will be lost

The Assets in Defined Contribution Plans

Defined contribution plans represent an increasing portion of assets in all private trusteed pension funds. According to EBRI data from the Quarterly Pension Investment Report (QPIR), total assets in trusteed pension funds amounted to $1.2 billion by the end of the first quarter of 1988. Defined contribution plans held $410 billion of those assets or 34.4 percent of the total. Defined benefit plans accounted for 55.2 percent of trusted fund assets and multiemployer plans for 10.3 percent. The share

held by defined contribution plans has increased considerably over the past 5 years from 29.9 percent of trusteed funds in 1982. Defined contribution plans are expected to continue to play an increasing role in financial markets.

The Prevalence of Lump-sum Distributions?

While changes in job tenure and modifications in the structure of pension plans and plan provisions will substantially affect future benefit payments, lump-sum distributions at retirement and upon job change are extremely important even today. Information on current distributions provides baseline data to help understand the future.

Preretirement Distributions

Many workers have received or can expect to receive preretirement distributions. In 1983, some 6.6 million workers said that they had received a distribution from their pension plan. Close to 85 percent were for amounts of less than $5,000. How these preretirement cashouts were used depended on the dollar amount of the distribution. Twenty-six percent of persons receiving preretirement distributions worth less than $5,000 used some for savings compared to 87 percent of persons receiving distributions worth more than $20,000. Over half of all persons receiving cash outs in the $5,000 to $9,999 range, spent, rather than saved, some or all of the distribution. Thus, a substantial proportion of benefits provided by employer-sponsored plans before retirement are never translated into retirement income. Furthermore, among workers who met ERISA standards for plan participation in 1983, 21 percent of those entitled to current vested benefits and 57 percent of those entitled to past vested benefits, report those benefits were received or could be received as a lump-sum distribution.

Distributions at Retirement

Current retirees are less likely to have received lump-sum distributions than future retirees. Defined contribution plans were less prevalent than they are today (or are likely to be in the future). Most retirees received pension benefits in the form of an annuity. And many employers regarded defined contribution plans as savings plans not as an integral part of retirement income security. Nonetheless, even among workers retiring in 1982, lump-sum distributions at retirement were quite common. Among those retirees, nearly 10 percent of all men with pension coverage from any job they worked on reported receiving a lump-sum distribution from the primary plan on their last job. The median value of that retirement distribution was $20,000. Another 4 percent of male beneficiaries covered by a pension plan received a lump-sum benefit from the primary plan on their longest job (other than their last job). The median value of that distribution was $10,000.

Lump-sum distribution amounts received by women from their primary pension plans were considerably lower and their recipiency rates higher than those of men. Nearly 15 percent of all women with pension coverage on any reported job received a lump sum distribution. Another 4 percent of women covered by a pension reported receiving a lump-sum distribution from the primary pension plan on their longest job; that distribution only averaged $2,000.

These figures underreport the prevalence of lump-sum distributions, however, as they only report distributions from primary plans and not from secondary plans. Furthermore, how retirees spend their distributions is not reported.

Potential Portability Losses

In order to determine potential benefit losses if benefits are spent rather than saved, a simulation model was used to construct examples of the economic consequences of pension portability. The following general assumptions are used to analyze cashouts from defined contribution plans. Workers are assumed to be first hired on a job with a pension at age 25 and work each year until age 65. The employee stays with the first employer for 5 years, then moves to a new job that lasts 10 years; the third job is also for 10 years and a fourth job lasts 15 years. Assets are assumed to grow at a rate of 7.5 percent. Illustrations were computed for four workers: (1) a female clerical worker in the service sector; (2) a female professional in retail trade; (3) a male production worker in manufacturing; and (4) a male professional worker in the financial sector. Benefits were made equivalent to those workers with four jobs would receive if they had been covered on each job by a defined benefit plan typical to their industry and occupation.

For Different Workers

The typical four-job worker with pension coverage is entitled to substantial pension benefits at retirement. The clerical worker would receive $25,626 in benefits from her plan and the retail-trade professional $106,448. The production worker would accrue $52,907 from his four jobs and the professional in financial services would have $145,664 (all in 1987 dollars). These sums would only be available at retirement if pension accruals from each of the three earlier jobs were maintained in the plan or rolled over into an IRA (or other employer plan) and saved. If the distributions were spent, the retirement income losses would be considerable. The female clerical worker could lose $18,290 and the retail-trade professional could lose $75,740. The production worker in manufacturing could lose $37,031 and the financial professional could give up $103,462 of his future pension. These losses are even greater than those workers would forego if they had spent distributions from comparable defined benefit plans. Accrued benefits from defined benefit plans are weighted towards later years when defined benefit plans have final pay formulas.

Of course, gains or losses in defined contribution plans depend upon the actual yield of the investments. Individuals can do better or worse than the market. Yet potential losses of over 70 percent of benefits represent a substantial fraction of retirement income for these illustrative workers.

For Small Distributions

Many early cash outs are for sums of less than $3,500. This represents the value of accrued benefits that employers can, at their discretion, distribute to employees who change jobs. For instance, all the cash outs calculated in the clerical worker example are less than $3,500. If a hypothetical employee received distributions of exactly $3,500 at each job change, and that sum were indexed for inflation, the total value of those cash outs at age 65 would be $21,254 (in 1987 dollars) under a 7.5 percent interest assumption. If the $3,500 figure were not indexed for inflation, the value of those $3,500 unindexed cash outs would still reach $15,766 (in 1987 dollars) by the time the person reached age 65. In other words, small cash outs would be worth a sizable percentage of, for instance, the full $25,633 cash value of pension benefits that a female clerical worker would receive at retirement. It would also represent a significant proportion of the $52,937 benefit (in 1987 dollars) accrued by a male production worker who held four jobs between ages 25 and 65.

Conclusions

What conclusions can be drawn from research findings about the need for increased portability and benefit preservation? We live in a world in which lump sum-distributions already go to many current workers and retirees. Most of these distributions are small and are spent upon receipt. Although job tenure has not become shorter, pension vesting standards have been reduced and more workers can expect to receive lump-sum distributions in the future. Current data indicate that defined contribution plans are becoming more important both in numbers and in the assets they command. Defined contribution plans are most likely to provide lump-sum distributions upon job change. These facts suggest that portability will be of increasing importance to tomorrow's retirees. But the aim of pension policy is always the delivery of benefits and not the policy in and of itself. Thus, projections of future retirement income can provide further insights.

Future Retirement Benefits

Earlier work has shown that today's retirees have income that is roughly equivalent to that of the rest of the population. Projections using a microsimulation model indicate that the baby boom can expect higher levels of retirement income than current retirees. Couples can expect income of $14,300 annually from pensions and Social Security. Single retirees can expect $11,300 a year. Much of these income gains can be attributed to the increased receipt of benefits from employer-sponsored plans and from higher benefit amounts from those plans. But the total pension replacement rate in retirement -- the ratio of pension and Social Security benefits to preretirement earnings -- will have fallen from 49 percent for the current generation of retirees to 45 percent for the baby-boom cohort. Part of this decline represents the realignment of Social Security benefits provided by the 1983 Social Security Amendments. These rates are based on the assumption that workers will spend their preretirement distributions just as they do today.

Better Benefits with Preservation

If portability legislation were enacted that ensured that preretirement distributions were saved until retirement, replacement rates would be higher. The gains would depend upon how portability was ensured, be it through voluntary incentives or mandatory rollovers. While no data are currently available on lump-sum distributions from secondary plans, a 1985 study conducted by the U.S. General Accounting Office suggested that savings plans could significantly raise replacement rates in retirement. That study presented calculations based on information from five different organizations. The study indicated that for employees who retire at age 65 with 20 years of credited service and a $20,000 salary, replacement rates are about 55 percent for those with no participation in a supplemental thrift plan, over 65 percent for those with 50-percent participation and 78 percent for those with a full 6-percent contribution to a supplemental plan. Thus, supplemental plans have the potential to replace preretirement earnings at rates in line with retirement income goals such as those put forward by the Carter Pension Commission.

Portability legislation, in part, intends to ensure that preretirement distributions are saved for retirement. Such rollovers frequently stem from distributions from secondary defined contribution plans. These supplements may have the potential to increase replacement rates beyond those currently forecast. There are trade-offs between the different portability proposals, however. On the one hand, little is known about the efficacy of further voluntary incentives. The Tax Reform Act's 10-percent surcharge on cash outs has yet to be evaluated. Voluntary incentives

possibly may not work. On the other hand, mandatory rollovers would certainly preserve benefits until retirement. But workers would lose the flexibility to use their funds for other purposes they determine to be in their best interests. Hence, Congress must decide whether the need for higher retirement income (be it for day-to-day living or crises such as long-term care) justify restricting choice. That decision may, in turn, depend on the increasing prevalence of lump-sum payments and the future structure of the retirement and health care systems.

Chairman PICKLE. Now, Ms. Moss, if you will proceed.

STATEMENT OF ANNE MOSS, DEPUTY DIRECTOR, PENSION RIGHTS CENTER, AND DIRECTOR, WOMEN'S PENSION PROJECT

Ms. Moss. The Pension Rights Center is a nonprofit group that has been working for the last 12 years to make the Nation's pension systems fairer to workers and retirees. We thank you for the chance to testify today on the issue of pension portability.

Many people talk about portability as the answer to a lot of problems of the pension system, but people's definition of portability varies according to who you talk to. Whatever their definition, people are using the word "portability" to mean a mechanism to keep them from losing pension benefits while changing jobs.

What portability means to us is the ability of workers to carry vested pensions with them from job to job. There are cases in which transferring pension benefits would be the answer to losing pension benefits, but in other cases there are more efficient ways of preserving pension benefits and minimizing job losses.

My testimony will pose solutions to some of the common problems we hear about from workers who change jobs. One problem we get the most complaints about is the effect of inflation. There are two ways the benefits of deferred vested participants could be indexed for inflation between the time the worker leaves and the date she is eligible to start collecting a pension.

One type of inflation proofing would require plans to allow deferred vested participants to withdraw benefits when they leave the job so the benefits can be transferred to some other retirement vehicle under the worker's control. Allowing withdrawal of benefits would be desirable in situations where a plan was not getting a realistic rate of return on investments: the Pension Portability Act of 1988, H.R. 1961, would provide for a trustee-to-trustee transfer of pension benefits to portable pension plans. We would like to see these types of transfers made directly to a plan, from a plan to a portable pension plan, and we would urge this be the only permitted type of lump-sum payment.

We also think that withdrawals should be made at the option of the participant rather than the plan. If Congress is concerned that participant withdrawals might deplete plan assets, one solution to that might be to put a cap on the maximum lump sum that could be withdrawn.

Another type of indexing could be done within the plan, it wouldn't be necessary for employees to take benefits out. This approach would be a form of performance indexing that would require a plan to adjust deferred pensions upward only in those years when the plan's rate of return on investments is better than the rate assumed at the time the participant left.

I want to point out that the British occupational pension law requires all plans to index deferred pensions. Plans could finance this type of inflation protection through Government-issued index bonds; that is bonds whose rate of return equals the inflation rate plus a specific real interest rate.

There is no question that some type of inflation protection is necessary for the many workers who cannot stay on the job up to retirement age, and for that reason we urge Congress to study the feasibility of various approaches to protecting deferred vested pensions against inflation.

I want to just mention two other types of pension problems that affect job changers that we are concerned about. One is a method of calculating benefits called the fractional rule that greatly penalizes workers who can't work right up until retirement age.

Another problem is a problem of vesting, that workers who change jobs frequently are less likely to become vested. Although legislation like TEFRA and the Tax Reform Act have shortened vesting requirements, we think there are still some gaps. For this reason we urge Congress to extend 5-year vesting to multiemployer plans, to preserve the TEFRA 3-year vesting rule for top-heavy plans and to consider whether 3-year vesting would be appropriate for all plans.

A new study from the Urban Institute, contracted by the National Senior Citizens Law Center, shows that a million more women could be collecting pensions 30 years from now if we had 3-year vesting.

And to conclude, I want to say the problems that job changes create are not necessarily solved by traditional portability proposals where workers carry benefits with them to the next job. Besides examining proposals which allow the transfer of pension credits from one job to the next, we think Congress should also look at the possibility of reducing vesting requirements, eliminating discriminatory benefit formulas and providing inflation protection within pension plans.

That concludes my statement. I would be happy to answer questions.

Chairman PICKLE. Thank you.

[The statement of Ms. Moss follows:]

STATEMENT OF ANNE MOSS,DEPUTY DIRECTOR, PENSION RIGHTS CENTER

Mr. Chairman, Members of the Subcommittee, I am Anne Moss, Deputy Director of the Pension Rights Center. I also direct the Center's Women's Pension Project.

The Pension Rights Center is a nonprofit organization that has been working for the past twelve years to make the nation's pension programs fairer and more responsive to the needs of workers and retirees.

We thank you for the opportunity to testify today on the issue of pension portability.

While policymakers have been discussing the pros and cons of pension portability for years, the subject has today gained new popularity. Many people, in fact, talk about portability as the panacea to all the problems of the pension system.

But what does the term "portability" actually mean? People's definition of portability varies according to their perspective. Nurses might think of it as a way to transfer benefits from one hospital to the next. Truck drivers might see it as pension "reciprocity," where work under different plans counts toward a single pension. A former manager might see portability as a way to protect her benefits from inflation until she reaches retirement age. Whatever the definition, people are clearly using the word "portability" to mean any solution which prevents them from losing pension benefits while changing jobs.

What portability actually means is the ability for workers to carry their vested pensions with them from job to job. In some cases transferring pension benefits would be the answer to losing pension benefits. But in many cases, there are more efficient ways of preserving pension benefits and minimizing the losses which come with job change.

Our testimony today will propose solutions to three of the most common problems we hear about from workers who change jobs: those who do not work long enough to earn a pension, or vest; those who do not work until retirement age and are penalized by the "fractional rule"; and those people who leave a plan and find their pensions decimated by inflation.

OVERVIEW

Mobility is an accepted feature of today's workforce. Whether voluntarily or involuntarily, a worker is likely to have many jobs before reaching retirement age. Half of all men have been on their current job less than 5.1 years, half of all women - 3.7 years. Women are often caught in the job-changing bind because of family responsibilities, sex discrimination and dead-end jobs. In addition, the entire workforce is in flux: companies are bought, sold, and merged. Plants are closed. More than ever before, workers are subject to layoffs, reductions-in-force, and economic recessions.

Most pension plans are designed to provide the maximum benefit to a career employee who works right up to retirement age. A worker with ten years under a pension plan is likely to receive much less than one-fourth of what a forty-year employee would receive. I will discuss specific ways this happens and propose solutions that Congress could adopt.

I. THE VESTING PROBLEM

One problem with job-changing is that a worker may lose all her benefits if she does not become vested. Thus, portability proposals will not help these people since they have not yet earned benefits to transfer.

Even since the enactment of ERISA's ten-year vesting rule, it is still likely that individuals will spend a career working under pension plans but never vest. Since 1984, most

small companies have been subject to three-year vesting through the Tax Equity & Fiscal Responsibility Act of 1982 (TEFRA). This provision has helped millions of secretaries, paralegals, dental technicians and nurses get benefits. A great deal of credit for the TEFRA top-heavy pension plan provisions goes to the Ways & Means Committee.

Starting in 1989, many more workers should be helped by the five-year vesting provision of the Tax Reform Act of 1986. But this does not solve the problem completely. Five-year vesting will not apply to workers under multi-employer plans, that is, plans negotiated by a union with several employers. This means that women going into non-traditional employment, such as construction and trucking, will vest only if they can stay on the job a full ten years. A provision of the Economic Equity Act, H.R. 2577, would extend five-year vesting to these plans. (The pension provisions have also been introduced separately as H.R. 2613, sponsored by Congresswoman Barbara Kennelly.) So, for people covered by multi-employer plans, portability is not the answer. They need shorter vesting and full reciprocity.

Even five-year vesting leaves some gaps since half of women workers have less than four years on the job. A recent study, contracted by the National Senior Citizens Law Center with the Urban Institute, shows that three-year vesting would permit over a million more women to be collecting pension benefits by the year 2020. This is why it is critical to retain the three-year vesting we already have under TEFRA, and start considering enacting three-year vesting for all workers under private plans.

RECOMMENDATIONS

- Congress should extend five-year vesting to multi-employer plans.
- Congress should consider requiring three-year vesting for all plans.
- Congress must retain the top-heavy TEFRA provisions.

II. THE FRACTIONAL RULE

The transfer of benefits under a portability scheme would not help workers whose benefits are reduced because of unfair benefit formulas which are pervasive through the pension system.

One way that mobile workers can lose benefits is through the use of the "fractional rule." This is a confusing method of reducing the benefits of a worker who does not stay on the job right up until retirement age, usually age 65.

Let's look at an example. Sarah M. assumed she'd get a decent pension after working 20 years for her employer. But when Sarah was laid off at age 55, she discovered the pension she would receive at age 65 would be reduced because she left the plan before retirement age -- even though she was not drawing her benefits early. Rather than getting a full pension based on all her years of work under the plan and final pay, she found that her pension was reduced by a fraction representing how many years she was away from age 65. This fractional rule reduced her pension substantially.

Here is a technical translation of how the fractional rule affected Sarah's pension.

> Sarah started work under the plan at age 35 and was laid off at age 55. Sarah's pension was initially figured to be $6,000 a year if she stayed working under the plan until age 65. But because she was able to work only

until 55, the plan only gave her two-thirds of the full pension she thought she had earned, or $4000. This reduction was imposed because she was only able to work twenty of the thirty years she needed to make it from age 35, the age she started work, to 65, retirement age under the plan.

This formula is complex and penalizes people for leaving a plan before age 65. In an increasingly mobile society, the fractional rule is out-dated and unfair.

RECOMMENDATION

- Congress should prohibit the use of the fractional rule in pension plans.

III. INFLATION

The third and most prevalent factor that hurts job changers is inflation.

Pensions are typically based on a worker's final average salary or wage. If a worker leaves a job twenty years before retirement age, the worker's pension will, at age 65, be based on the wages of twenty years ago. According to one study, a worker who has four jobs, for ten years each, would get about half the pension of the worker who works continuously for 40 years under a single plan (assuming a 6% inflation rate and that all plans are identical).

Proponents of portability say that the transfer of benefits from one plan to another would solve this inflation problem. The Pension Rights Center takes the position that it isn't always desirable for an employee to take money out of a pension plan when there may be more efficient means of reaching the same end.

I'm going to discuss two ways that the benefits of "deferred vested" participants could be indexed for inflation between the time the worker leaves and the date she is eligible to start collecting the pension. One type of indexing could be accomplished while keeping money in the plan; the other would require the transfer of money from one account to another, but differs somewhat from a legislative proposal now being considered by Congress.

1. Performance Indexing. One approach would be a form of "performance indexing" that would require a plan to adjust deferred vested pensions upward only in those years when the plan's rate of return on investments is better than the rate assumed at the time the participant left the plan. It should be noted that the British occupational pension law requires all plans to index deferred vested pensions by the lesser of the Retail Price Index or five percent.

Plans could finance this type of inflation-protection through government-issued "index bonds", that is, bonds whose rate of return equals the inflation rate plus a specific real interest rate.

2. Benefit Transfers. Another alternative would be to require plans to allow deferred vested participants to withdraw their benefits when they leave the job, so that the benefits can be transferred to some other investment vehicle under the control of the participant. Allowing withdrawal of benefits would be desirable in situations where a plan was not receiving a realistic rate of return on investments. The Pension Portability Act of 1988, H.R. 1961, would provide for trustee-to-trustee transfers of pension benefits to Portable Pension Plans. These transfers should be made directly from a plan to a Portable Pension Plan and we would recommend that this be the only permitted type of lump sum payment. We

would also urge that withdrawals be at the option of the participant rather than the plan. If Congress is concerned that participant withdrawals would risk depleting plan assets, a cap could be placed on the maximum lump sums. For example, an earlier Economic Equity Act would have limited participant withdrawals to benefits not over $7000 in present value.

There is no question that some type of inflation protection is necessary for the many workers who cannot stay in the job up to retirement age. The National Senior Citizens Law Center - Urban Institute study shows that by the year 2020, women would be collecting benefits over 18% higher if they were permitted to reinvest deferred vested benefits.

RECOMMENDATION

- Congress should study the feasibility of various approaches to protecting deferred vested pensions against inflation.

The problems that job changes create then are not necessarily solved by traditional "portability" proposals -- where workers carry benefits with them to the next job. Besides studying proposals which allow the transfer of pension credits from one job to the next, Congress should also examine the possibilities of reducing vesting requirements. eliminating discriminatory benefit formulas and providing inflation-protection in pension plans.

Chairman PICKLE. Now we have testimony from Mr. Grubbs. If you would proceed, sir.

STATEMENT OF DONALD S. GRUBBS, JR., PRESIDENT, GRUBBS & CO., INC.

Mr. GRUBBS. Thank you.

I have been working with pension plans for over 30 years. I don't represent any organization here today. A lot of workers take lump-sum distributions from plans, and as a result they spend the money or they invest it poorly, and it doesn't get applied to provide income for life, and that is the problem we need to solve.

I advocate a Federal portable pension fund, and in my written testimony, Appendix A specifies in detail why a portability fund is needed, just how it will work, and it shows it would be currently feasible, as the Senate envisioned in its version of ERISA.

I want to skip on to two more limited steps that Congress could take today that would definitely enhance portability. First, consider John Doe, a participant who has just terminated employment. He is age 60 and single and has $18,000 of taxable income unrelated to pensions. Therefore, under the Tax Reform Act, he is in the 28-percent tax bracket. He reasonably expects to remain in the 28-percent tax bracket or higher, if Congress increases the tax rates. Under his pension plan he has three choices: he can take a lump-sum distribution of $80,000, or he can take an immediate monthly pension, or he can take a deferred monthly pension.

If he elects a deferred monthly pension or an immediate monthly pension, those pension payments are going to be taxed at the rate of 28 percent. And if he takes a lump-sum distribution and rolls it over into an IRA, whenever he gets his money out of an IRA, that is going to be taxed at 28 percent. But if instead he takes a lump-sum distribution and does not roll it over, if he goes and spends it or anything else, he only pays 15 percent tax.

We have given John Doe a pretty strong incentive not to preserve his pension. The special tax treatment of lump-sum distributions is a disincentive to preserving pensions either within existing plans or rollover IRAs. If anything, the tax incentive ought to be exactly the opposite, encouraging individuals to preserve their pensions.

The solution is simple—eliminate the special tax treatment of lump-sum distributions and tax all distributions from qualified plans as ordinary income.

In addition to encouraging the use of existing means of portability, this change would have other advantages. It would definitely increase tax revenue in the long run and would probably increase revenue in the short run as well. It would simplify a portion of the Internal Revenue Code which many taxpayers have difficulty understanding and would actually shorten the code itself, both worthwhile objectives. It would eliminate one IRS form and in some cases also eliminate the need to make an attachment to that form. It would save fees that people have to pay tax advisers for explaining the alternatives to them and making elaborate projections to determine which is best.

In addition to everything else, elimination of the favorable tax treatment of lump-sum distributions would make taxes fairer. If John Doe is already in the 28-percent tax bracket, why should he pay only 15-percent tax on any income of any kind?

I have one other modest proposal dealing with rollovers between the Federal thrift savings plan and the rollover provisions under the code. Unlike private pension plans, individuals do not have the ability to take distributions from the thrift savings plan and roll it over into an IRA. They should. It is an easy change to make in the law.

Similarly, individuals who take a job in Federal employment and will be covered under the thrift savings plan should be able to roll over distributions from their prior private employer into the Federal thrift savings plan.

Thank you.

[The statement of Donald S. Grubbs follows:]

PORTABLE PENSIONS

By

DONALD S. GRUBBS, JR., F.S.A.

GRUBBS AND COMPANY, INC.

PRESENTED TO

SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

JULY 12, 1988

My name is Don Grubbs. I am a Fellow of the Society of Actuaries and am admitted to the District of Columbia Bar. For over 30 years my primary occupation has been working with pension plans in a variety of capacities. I represent no organization today, but I do try to represent the needs of American workers.

Vesting and Portability

Vesting and portability of pensions are closely related. Vesting prevents accrued pension benefits from being forfeited. Portability is an effort to preserve the vested pension in order to meet its intended purpose of providing pension income in retirement.

The Present Extent of Portability

From 1979 to 1981, under contract with the Department of Labor, I was responsible for the broadest study ever undertaken of the extent of portability under single employer pension plans. I have furnished the Subcommittee a copy of our final report on that study. I shall be happy to answer any questions the Subcommittee may have regarding that study and the present extent of portability. In a nutshell, portability is quite limited at present.

The Need for a Federal Portable Pension Fund

Upon termination of employment the value of a participant's vested pension is often paid out in a lump sum distribution. To encourage the preservation of these distributions to meet their intended purpose of providing pensions instead of being spent currently, ERISA allowed tax-free rollover of the amounts received into an IRA or another pension plan. Although this has helped preserve some pensions, in most cases the amounts received have not been rolled over. In many cases the distribution has been spent currently, leaving none of it to meet the intended retirement income needs.

The only way to assure extensive portability is to establish a federal portable pension fund. Appendix A to my testimony explains in detail why such a portability fund is needed, specifically how it could be designed, and how it would work. It demonstrates that a federal portable pension fund is currently feasible.

The establishment of a federal portable pension fund should be based upon detailed consideration. It could not be implemented before the end of this year. The remainder of my testimony

addresses two more limited and very simple steps that could be implemented at once. These two steps would significantly enhance portability of pensions.

End the Tax Disincentive to Portability

Consider John Doe, a participant who has just terminated employment. He is age 60 and single and has $18,000 of taxable income unrelated to pensions. Therefore he is in the 28% tax bracket. He reasonably expects to remain in the 28% bracket, or higher if tax rates are increased. Under his pension plan he is entitled to receive either a lump sum distribution of $80,000, or a deferred monthly pension beginning at age 65, or an immediate monthly pension, all three alternatives calculated to have equal value. If he elects a deferred monthly pension or an immediate monthly pension, he expects to pay 28% tax on the pension received. If he receives a lump sum distribution and rolls it over into an IRA to preserve it, he expects to pay 28% tax on the distribution whenever he receives it, regardless of the form in which he receives it. But if he elects a lump sum distribution and does not roll it over into an IRA or another pension plan, he can elect five-year averaging treatment and only pay 15% tax. We have given John Doe a pretty strong incentive not to preserve his pension.

The special tax treatment of lump sum distributions is a disincentive to preserving pensions, either within existing plans or in rollover IRAs. If anything, the tax incentive should be exactly the opposite, encouraging individuals to preserve their pensions. The solution is simple. Eliminate the special tax treatment of lump sum distributions and tax all distributions from qualified plans as ordinary income.

In addition to encouraging the use of existing means of portability, this change would have other advantages. It would definitely increase tax revenue in the long run, and would probably increase revenue in the short run as well. It would simplify a portion of the Internal Revenue Code which many taxpayers have difficulty understanding, and actually shorten the Code itself, both worthwhile objectives. It would eliminate one IRS form, and in some cases the need to construct a worksheet to be attached to the form. It would save fees paid to tax advisors for explaining the alternatives and making elaborate projections under various assumptions to try to determine the best tax alternative.

In addition to everything else, elimination of favorable tax treatment for lump sum distributions would make taxes fairer. If John Doe is already in the 28% tax bracket, why should he pay only 15% tax on any income of any kind?

Rollovers into the Thrift Savings Plan for Federal Employees

The Code allows tax-free rollovers into other pension plans in order to encourage the preservation of pensions, but most employer plans have not accepted or encouraged the receipt of rollovers. However, for an employee who transfers from a private employer into federal government employment, no rollover is permitted. An individual hired to work in the office of a Member of Congress cannot rollover the distribution he received from his prior pension plan into the federal Thrift Savings Plan.

I recommend that both the Internal Revenue Code and the Federal Employees' Retirement System Act of 1986 be amended to allow such rollovers. This would be beneficial to federal employees and encourage them to preserve their pensions, as well as setting an example to other employers to accept rollovers.

Similarly, the Code should be amended to allow rollovers from the federal Thrift Savings Plan into an IRA.

APPENDIX A

A FEDERAL PORTABLE PENSION FUND

By

DONALD S. GRUBBS, JR., F.S.A.

This presents a brief summary of the reasons why a federal portable pension fund is needed, and considers specific elements of how it should be designed.

A federal portable pension fund is needed now to preserve pensions that are vested under current law. Tax Reform Act requirements to provide more rapid vesting beginning in 1989, producing more small vested pensions, makes the need for a federal portable pension fund even greater.

Need

A federal portable pension fund is needed to preserve and enhance the pensions of workers who terminate employment before retirement age.

In the past it was suggested that portability did not really matter if vesting provisions were adequate. It was argued that it really would not matter if a worker received four small vested pensions from four employers instead of receiving one combined pension from a single source. But there are several reasons why the lack of portability often causes the individual to receive less retirement income.

First there is a practical problem the employer faces in trying to administer small vested pensions for the terminated employee. The problems of keeping records of the small pension, of keeping track of the former employee over many years, of sending the terminated vested employee summary annual reports and notices about plan changes, of locating him when benefits become payable, and of administering the small amount when it becomes payable, make the administrative costs high in relation to the amount of the benefit.

ERISA provided needed relief to the employer or other plan sponsor, from the disproportionately high administrative costs for small vested pensions. However this relief works to the detriment of the terminating employee. Under ERISA a pension plan may provide for the "cash-out" of the employee's vested benefits when the individual terminates employment. If the entire interest of the terminating employee is not in excess of $3,500, an employer can "cash-out" the employee's accrued benefit without the employee's consent. This provision recognizes the administrative costs associated with small pension benefits. Lump-sum distributions of amounts over $3,500 can only be made with the employee's consent, unless the plan sponsor is willing to accept certain adverse consequences. However, employees are tempted to accept the amounts offered so that they may gain discretionary use over them.

Although IRAs coupled with the rollover provision provide portability for the employee who wants to use them, this has had only limited effect. Most individuals receiving lump-sum distributions spend these amounts rather than rolling them over into an IRA for retirement income purposes. This is particularly true of lower income workers with the greatest need for a pension in their later years. Furthermore, even if the amounts are rolled-over into an IRA, an individual can still draw upon the IRA prior to retirement, although there are tax penalties to discourage premature withdrawals.

If the pension plan funds are paid out as lump sum distributions and not used for retirement income, it defeats the legislative intent behind the cash-out provisions of ERISA. The Conference

Report states, "Despite the foregoing provision, generally, the conferees prefer that all amounts contributed for retirement purposes be retained and used for those purposes. Thus, a plan could provide for no cash-out, or the employee's collective bargaining unit might wish to bargain for such a provision". If a portable pension fund were available into which these amounts could be channeled, the pensions could be preserved for the employee while still avoiding the administrative burden upon the employer. But in the absence of a central portability fund, many employers will very naturally pay the vested amounts in a lump sum directly to the terminating employee.

Second, in addition to this direct defeat of pensions, the lack of portability discourages employers from liberalizing their vesting provisions beyond ERISA's minimum requirements. An employer whose objective is to provide a retirement income for employees has no incentive to move to earlier vesting if the result is small pensions vested after a few short years, which must be cashed out to solve the practical problems of administering small vested pensions. Such earlier vesting does not provide the retirement income the employer intends. If a central clearinghouse were established to accept and administer small pension amounts, it might make earlier vesting feasible from a cost-benefit standpoint for additional employers. Mobile workers would have a greater opportunity to receive retirement income reflective of most of their years of employment rather than just their longest job. The worker who changes jobs every three or four years has just as great a need for a retirement income as the one working five or more years with the same company.

Most of those who have studied the retirement income needs of the aged recognize that Social Security fills an essential role in supplying a floor of income to most retired workers. Although Social Security alone generally provides the bare minimum essentials for survival, it does not provide retired workers with what is commonly regarded as an adequate retirement income. That is why private pensions are needed to supplement the benefits from Social Security. Social Security provides full portability, providing benefits that reflect all of a worker's covered employment regardless of how often he changes jobs. There is a definite need for greater portability of private pensions, to increase their ability to preserve vested pensions as a vital supplement to the benefits under Social Security. A federal portable pension fund can meet those needs if it is wisely designed in a way that does not create greater problems than it solves.

Historical Background

a. President's Committee on Corporate Pension Funds
In January 1965, the President's Committee on Corporate Pension Funds issued its report "Public Policy and Private Pension Programs: A Report to the President on Private Employee Retirement Plans." The report recommended study of an arrangement providing for the portability of pension credits with allowance for voluntary employer participation. It stated that some type of central clearinghouse might be developed.

b. Retirement Income Security for Employees Act (H.R. 10470)
Voluntary portability provisions were included in the Senate-passed version of ERISA. Title III of the proposed "Retirement Income Security for Employees Act" (H.R. 10470 as passed by the Senate on September 18, 1973) would have established a Pension Benefit Portability Fund within the Pension Benefit Guaranty Corporation. Each employer could decide whether to participate in the portability program. If an employer elected to participate, each terminating employee could decide whether the value of his own accrued benefit was to be transferred to the Portability Fund.

The Conference Committee dropped the Senate's portability provisions, but directed the Joint Pension Task Force to make a full study and review of the means of providing for the portability of pension rights among different plans.[1]

Potential Problems of a Portable Pension Fund

a. Administrative Burden Upon Pension Plans

If a portable pension fund were so designed or operated that it significantly increased the present administrative burden upon plan sponsors and administrators, this could be expected to increase plan terminations and decrease the formation of new plans. This would be most damaging to American workers and to the private pension movement.

b. Administrative Cost to the Government

Any new program has costs for the government to operate it. However, the difference in cost of operation between a program carefully designed for efficient administration utilizing appropriate existing facilities, and one not so designed, can be very significant. This is important, regardless of whether the cost is paid by the government or passed on to participants by the fund.

c. Cash Flow Problems for Plans

Most defined benefit pension plans provide the majority of their benefit payments in the form of a monthly income payable for life, and not in the form of lump sum payments. Usually only small amounts, previously referred to, are made available as lump sum payments. Therefore the flow of benefits from the plan is fairly regular, usually not exceeding the current year's contributions and investment income. Thus the plan usually has a positive cash flow and there is no need to liquidate investments to make benefit payments.

If a portable pension fund were to require plans to make large lump sum transfers to the portable pension fund in lieu of making monthly pension payments, this could force plans to liquidate investments to make the transfers. Such transfers could adversely affect the funded status of benefits remaining in the private pension plan, particularly if it were necessary to liquidate investments at a time when market values were temporarily depressed. In addition, such a requirement may cause the plan's trustee to invest in assets with greater liquidity or less market value volatility in order to meet cash flow requirements without losses, but with a resulting lower rate of investment return.

For many defined benefit pension plans the assets of the plan are less than the value of vested benefits. In such a case, a transfer for one participant of assets equal to 100% of the value of his vested benefits automatically reduces the ratio of the remaining assets to the value of the vested benefits of the remaining participants. Not only could this reduce the benefit security of the remaining participants, in some circumstances it could increase the potential liability of the Pension Benefit Guaranty Corporation under Title IV of ERISA, and the potential contingent liability of employers.

Thus if laws required private pension plans to make transfers to the portable pension fund of amounts substantially greater than the amounts that would otherwise be paid in the form of lump sum payments, serious problems could occur. No such problems are created by the transfer to a portable pension fund of amounts which would otherwise be paid in a lump sum in the absence of such a fund.

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[1] ERISA sec. 3022(a)(2).

Requirements for Maximum Success

To be most successful a federal portable pension fund should have the following characteristics:

(1) Utilization of amounts otherwise payable in a lump sum to provide a life income instead
(2) Assurance that the expected pensions will be paid
(3) Maximum pension income for participants from the amounts transferred to the fund
(4) Pensions which meet the problem of inflation
(5) Equity to both employers and employees
(6) Capacity to be easily understood by employers and employees
(7) Minimum administrative costs for the portable pension fund
(8) No significant administrative work or cost or other adverse consequences for private pension funds
(9) High acceptability

Mandatory or Voluntary

One of the principal objectives of many plan sponsors in establishing a pension plan is to provide workers a retirement income. Such plan sponsors generally allow lump sum distributions only reluctantly for small pensions, and then only because no administratively feasible alternative is available. Many such plan sponsors could be expected to welcome the portable pension fund as an aid in accomplishing their objective of providing retirement income. Their pension plans could contain a provision allowing transfer to a government portable pension fund if such a fund is established.

Other plans, particularly profit-sharing and thrift plans, are not primarily designed to provide retirement income, and have a history and tradition of paying lump sum distributions to most terminating employees. In such plans both employers and participants could be expected to resist any mandatory requirement that cash-outs be transferred to the portable pension fund, rather than paid in a lump sum.

The needs of both groups can be satisfied if participation in the portable pension fund is voluntary for each sponsor. Each plan document could specify whether the plan should provide a transfer of (a) all cash-outs (i.e. amounts which the plan would otherwise pay as a lump sum rather than as a life annuity), (b) no cash-outs, (c) only certain defined cash-outs (e.g., those under $3,500), or (d) cash-outs for those participants who elect them.

Amount of Transfer to the Fund

A plan may make a distribution of the present value of a participant's entire nonforfeitable benefit if the amount of distribution does not exceed $3,500 or if the employee elects to receive it.[2] The Internal Revenue Service has issued regulations regarding these cash-outs. Many plans now have provisions for such cash-outs and are currently administering them. It would seem appropriate that the amount to be transferred to the portable pension fund would be this same present value of the participant's entire nonforfeitable benefit. This amount would create no new problems since it is already regulated by the Internal Revenue Service and administered by plan administrators. It would merely be transferring to the portable pension fund the amount which the plan is otherwise permitted to pay to the employee in cash. To require payment of any more than this would increase the cost to the plan and discourage use of the portable pension fund. To allow payment of any less would be inequitable to participants.

Under plans with mandatory employee contributions the vested benefit consists of two parts, that attributable to employee contributions and that attributable to employer contributions. A plan may now provide for the payment of one or both of these parts

[2] ERISA sec. 204(d), I.R.C. sec. 411(a)(7).

in a lump sum upon termination of employment. If the combined amount is paid, only the employer-provided portion may be rolled over into an IRA; thus there are circumstances under which it would be appropriate to transfer to a portable pension fund the employee-provided portion, the employer-provided portion or the combined amount. Plans would be required to separately identify any employee contributions for tax purposes, as they are already required to do when benefits are paid.

Decisions as to which portion of the vested benefit should be transferred to the portable pension fund, which part would be paid in cash and which part retained in the employer's fund could be left to the provisions of each particular plan document.

Some plans provide for separate voluntary employee contributions whether or not there are mandatory employee contributions. It would be feasible to allow the transfer of these voluntary employee contributions to the portable pension fund independently of whether there is a transfer of the employer-provided benefit or the benefit derived from mandatory employee contributions.

Defined Benefit or Defined Contribution

Should the portable pension fund itself be operated as a defined benefit plan, as a defined contribution plan, or as a combination of the two?

Transfers to the portable pension fund would be made from both defined benefit and defined contribution plans. With respect to amounts transferred from a defined contribution plan, the natural approach would be to preserve the transfer in an individual account, operating the portable pension fund as a defined contribution plan. There are no particular problems in doing so.

It may also seem natural for the portable pension fund to preserve as defined benefits those vested amounts transferred from defined benefit pension plans, but there are substantial problems in doing so. With respect to the defined benefit plans, the amounts transferred would represent the value of vested benefits which have an almost infinite variety of retirement ages, form and amount of annuities. Any effort on the part of the portable pension fund to preserve this variety of retirement ages, death benefits and forms of annuity would create an extremely complex task of administration on behalf of the portable pension fund. In addition, the portable pension fund might be able to provide more or less annuity than the amount which was vested under the private plan because the portable pension fund might have a different rate of investment earnings or might use different assumptions regarding mortality and other factors from those used to determine the lump sum distribution from the private plan. This problem disappears if the amount transferred from a defined benefit plan, like that transferred from a defined contribution plan, is deposited in an individual account for the participant, and the entire portable pension fund is operated on a defined contribution basis. This is the same treatment that would be provided if the amount were rolled over into an IRA. It is appropriate since the amount transferred is the amount of cash to which the employee might otherwise be entitled; and thus it is appropriate to establish an individual account for him equal to the cash transfer and to provide whatever benefits might be provided by his individual account.

The individual account could be credited with its share of the investment income of the portable pension fund (net after investment expenses).

Time of Benefit Commencement

Under the method of funding suggested herein, an individual's account will continue to grow until benefits commence, at which time it will be converted into a monthly income payable for life. The conversion factor would take account of the shorter life expectancy of older individuals, providing them more monthly income

for each $1,000 of account balance than for younger individuals. The individual whose benefit begins at a later age would receive larger monthly payments than if he had retired earlier, but for a shorter period of years, as already occurs under Social Security and under many private pension plans. Each employee would receive a benefit for which the present value at retirement equals his account balance. Thus there is no inherent advantage or disadvantage in having payments start earlier or later.

Most workers continue to earn income until their Social Security benefits begin. At that time their earnings stop and the smaller Social Security benefits begin, so this is ordinarily the time when additional income is needed. Under Social Security a retired worker can elect to have his full benefits begin at age 65, 66 or 67, or reduced benefits begin as early as age 62. A disabled worker can have his Social Security benefits begin at any age. Currently, a worker not yet retired, because of the earnings test, does not ordinarily begin receiving benefits until age 70.

Administratively it would be simplest to have benefits under the portable pension fund begin at the same time as benefits under Social Security, which is ordinarily the time they are needed. Commencement at that time could be automatic unless the employee has elected earlier commencement.

What should be the minimum age to allow benefits under the portable pension fund to begin? Payments under qualified pension plans are subject to a 10% penalty tax upon distribution before age 55 (age 59 1/2 if not upon separation from service), or at disability if earlier. Some pension plans allow retirement at age 55, and some even earlier, although benefits are usually reduced for retirement before age 65. Most plans experience few actual retirements before age 62, even if retirement is allowable at earlier ages, since few employees can afford to retire before age 62 when Social Security benefits begin. There is no clear-cut answer as to the minimum age when benefits should be allowed to begin. Demographic shifts in the United States indicate a need to raise the average retirement age in this country. It is recommended that benefits not be permitted to commence before age 55 except upon earlier disability. In any case the minimum age should be set at a <u>whole</u> year of age and not a half year. Ordinary people know when their 55th or 60th birthday is, but don't know when they turn 59 1/2.

Should there be a maximum age to begin pensions from the portable pension fund? Benefits under IRA's and qualified plans are required to begin no later than the April 1 following the year the individual attains age 70 1/2. Otherwise pensions almost never begin before retirement or the termination of employment. Social Security benefits usually begin at age 70 for those employees who continue working full time past that age, since the earnings test no longer applies at age 70. For administrative reasons it would be simpler to have portable pension fund benefits begin automatically when Social Security benefits begin, which may normally be any time between age 62 and age 70. A half year of age, such as 70 1/2, should not be used, since individuals generally do not note when they attain half ages.

Some individuals are never eligible for benefits under Social Security because they have insufficient quarters of coverage under that program. For such individuals benefits could commence automatically at age 70 if they have not elected earlier commencement.

<u>Form of Benefit and Election</u>

At retirement, should a participant's account balance be paid as a lump sum or as a life annuity? The whole purpose of the portable pension fund is to preserve, for the purpose of providing an adequate retirement income, the amounts that would otherwise be cashed-out. Amounts paid as a lump sum may be spent immediately, leaving the participant to live in poverty in his old age.

Therefore the account balance should be used for retirement income and not paid out in a lump sum during the lifetime of the participant. When the individual is eligible to receive retirement benefits his entire account balance could be withdrawn and applied to provide him an annuity payable for life. This does not preclude payment of lump sum benefits to survivors upon death.

Retired individuals need an income which continues for life, and the purpose of pension plans is ordinarily to provide such an income. Therefore all payments should be in the form of an income which continues for at least the lifetime of the participant, or the combined lifetimes of the participant and his spouse.

There are many forms of annuity (e.g., life annuity with 60 payments guaranteed) payable under pension plans. Both to make the plan understandable by participants and to minimize administrative costs, the variety of forms of annuity needs to be limited.

The maximum amount of monthly benefit can be paid if no benefits are payable after death. However, if the benefits are payable only during the participant's lifetime, some participants would die after receiving only one or a few monthly payments, forfeiting most of their account balance. One form of annuity found in insurance and annuity contracts is the cash refund annuity, under which a payment is made at death equal to the excess of the individual account at annuity commencement over the total of monthly benefits paid. The amount of income that can be provided under a cash refund annuity is slightly less than could be provided if no refund benefit is payable at death. The amount of reduction required to add a cash refund feature depends upon age, but is approximately 6%.

Some participants have a spouse who is dependent on their income. Other participants have no spouse, or the couple has decided that it is unnecessary to provide for the spouse, who may have substantial alternative assets or income. Congress has decided that each qualified plan providing an annuity must provide a qualified joint and survivor annuity as one of the alternative forms of benefit, and that benefits to a married participant must be paid in the form of a qualified joint and survivor annuity unless the participant has elected otherwise with spousal consent. A qualified joint and survivor annuity is an annuity payable for the lifetime of the participant, with from 50% to 100% of the amount payable to the participant's spouse for life after the participant's death. The amount of monthly benefit is actuarially reduced to have the same cost as the single life annuity, so that a 100% continuation to the spouse requires a greater reduction in benefit amount than a 50% continuation. Most pension plans have used exactly 50% for the amount continued to the spouse, while other plans have used 100%.

The joint and survivor annuity can also have a cash refund feature, so that if both the participant and the spouse die before receiving combined payments equal to the account balance at retirement date, the excess of the account balance will be payable as a death benefit to a beneficiary. The amount of reduction required to add a cash refund feature depends upon age, but is approximately 2% in the case of a 100% joint and survivor annuity and 4% in the case of a 50% joint and survivor annuity.

Thus the needs of participants could generally be met by providing three alternatives:

(1) a single life annuity with cash refund,
(2) a 50% joint and survivor annuity with cash refund, and
(3) a 100% joint and survivor annuity with cash refund.

I recommend that the 100% joint and survivor form be the automatic form for all married participants unless the participant elects otherwise with spousal consent.

Annuity Factors

Annuity factors are required to convert the account balance into an amount of monthly income. Such annuity factors are calculated based upon assumptions of mortality, interest and other factors. The administrator of the portable pension fund should be allowed discretion to adopt suitable factors upon the recommendation of the fund's actuary, and to revise the factors from time to time as conditions merit.

The annuity factors should not differ by sex. Thus monthly benefits for males and females for whom equal transfers were made to the fund would be equal.

It would be possible to insure annuities with commercial insurance companies, an approach already adopted by the Thrift Savings Plan for federal employees. Under this approach the task of selecting annuity factors could be relegated to insurance companies, subject to governmental contracting.

Cost-of-Living Adjustments

A fixed-dollar pension gradually decreases in purchasing power and is, in effect, a decreasing pension. It is highly desirable from the participant's viewpoint to have any pension paid contain automatic adjustments for cost-of-living increases. Social Security benefits are fully adjusted for cost-of-living increases. Most private pension plans lack automatic cost-of-living adjustments, because of their substantial cost. Private pension plans which do have automatic cost-of-living adjustments usually set a maximum on the amount of annual increase, for cost control purposes. Some plans without automatic adjustments make occasional ad hoc adjustments to help retirees meet the inflation problem.

Cost-of-living-adjusted pensions are substantially more expensive than fixed pensions, and the greater the increases in pension, the greater the increase in cost. To keep the portable pension plan financially sound, the initial amount of pension would need to be smaller for cost-of-living-adjusted pensions than if fixed pensions were provided. The amount of adjustment is illustrated below for persons retiring with a single life annuity at age 65:

Annual Increase In Benefits	Approximate Initial Reduction Required
2%	14%
4%	28%
6%	40%

If the cost-of-living increases are unlimited, it is impossible to know how much of an initial reduction is required, so a maximum limit is required if the fund is to be self-supporting. This requires a compromise between the objectives of keeping pace with the cost-of-living and providing an initially adequate pension. Some private employers have selected 4% as the point of compromise. It is recommended that all annuities provide an initially reduced income, increasing automatically by 4% per year.

Death Benefits Before Retirement Income Begins

If a participant dies before his retirement income begins, his account balance could be paid to his beneficiary. Of course this reduces slightly the amount of annuity that could otherwise be provided if such balances were used to increase pensions for other participants.

If the beneficiary is the participant's spouse, the beneficiary could be allowed the option of applying the account balance to provide a life annuity with cash refund.

Designation of Beneficiary
As under qualified plans, the beneficiary to receive any death benefits with respect to a married participant should be the participant's spouse unless the participant elects otherwise with spousal consent.

Investment of Fund Assets
For a portable pension fund to maintain its credibility and distinct purpose, the amounts it receives could be kept separate and apart from other funds it may receive, control, or have under governmental jurisdiction.

The fund should be invested in the sole interest of participants and beneficiaries. If the long term investment return is increased, this will increase the benefits provided to participants and beneficiaries.

Recent history has shown that the market value of securities may fall sharply at the same time that a rising cost-of-living increases the need for pensions. It is therefore inappropriate to allow pensions to fluctuate with market values. If the amount of benefits payable were stabilized, while the asset value of the fund were able to fluctuate widely, this could lead to deficits in the fund. These problems can be avoided if the fund is invested in long term bonds which are valued at amortized value and generally held to maturity. In addition, if a governmental fund were to acquire substantial amounts of common stock with voting rights, this could create serious questions of the exercise of the voting rights under control of the portable pension fund.

But there are differences of opinion concerning whether the long-term total investment return will be higher for bonds or for stocks. If stocks produce a higher return, this would be an advantage to investing in stocks.

It is in the interests of participants that the fund earn the highest rate of return consistent with prudent requirements for safety of principal and needs for liquidity. To this end the investment could be managed by banks, insurance companies and other institutional investors with proven ability to manage investment portfolios. Such investors are apt to be most successful if they are given the widest discretion within the basic "prudent person" rule. (See ERISA sec. 404(a)(1).)

The Federal Retirement Thrift Investment Board is already established to invest pension funds for federal employees. Since it is already functioning well, it could be the body to administer the Portable Pension Fund. It would be wasteful to establish a duplicative facility. The Fixed Income Investment Fund established by this body would appear to be a suitable investment vehicle for the portable pension fund. Investment in U.S. government securities would not be in the interests of participants and beneficiaries because of the lower yields of government securities.

Administration of the Portable Pension Fund
The Federal Retirement Thrift Investment Board is already established to administer individual accounts for federal employees. This includes maintaining their records after they are no longer federal employees. The administrative functions for a federal pension portability fund would be essentially the same. Since the Board is already functioning well, it could be the body to administer the Portable Pension Fund. It would be wasteful to establish a duplicative facility.

The Social Security Administration already has the responsibility of notifying individuals of any deferred, vested benefits to which they might be entitled under qualified pension plans. It is the agency which most Americans already contact when they want their retirement income to begin. It could assist the Federal Retirement

Thrift Investment Board in the process of contacting or notifying individuals when their benefits are to commence if the Board is unable to contact them.

Administrative Expenses

Administrative expenses may be divided into two parts: (1) those investment expenses directly related to investment of the fund and (2) general expenses. Investment expenses are clearly an appropriate reduction in investment income, so that participants could be credited with net investment income after deducting investment expense.

General expenses could also be deducted from investment income. Alternatively general expenses could be paid from general revenues of the federal government, just as most other governmental expenses for the pension reform legislation have been.

In either event, because of higher start-up costs when the fund is small, the initial expenses might consume an unreasonably large part of investment income, discouraging use of the portable pension fund. Therefore Congress may wish to limit any expenses subtracted from the fund to 1% of fund assets, subsidizing the start-up expenses in the early stages.

Modification of ERISA Repayment Provisions

ERISA section 204(d) and Internal Revenue Code section 411(a)(7), which provide for the cash-out of lump sums, also state that if a partially vested employee receives a lump sum distribution of his vested pension and is later reemployed, the plan must provide full past service credit for the period for which he has already received a benefit unless (a) the plan allows him to repay his distribution (together with 5% interest in the case of a defined benefit plan) and (b) he fails to do so. Under such a provision, if the distribution had been transferred to the portable pension fund, the participant would not have the money available to transfer back. Some modification of this provision would be needed. One solution would be to require reinstatement, upon reemployment, of only the nonvested portion of the benefit, with no requirement for repayment of the distribution.

Another repayment provision is found in ERISA section 203(a)(3)(D) and Internal Revenue Code section 411(a)(3)(D). Under these sections a plan may provide that withdrawal by an employee of his own contributions will result in forfeiture of the employer-provided benefit, provided (a) the employee is less than 50% vested in the employer-provided benefit and (b) the plan allows the employee to repay his withdrawal with interest and have his employer-provided benefit reinstated. The appropriate solution (and a better policy solution even if a portable pension fund is not established) is to prohibit the forfeiture of otherwise vested benefits upon the withdrawal of employee contributions. An alternative solution, similar to that indicated in the preceding paragraph, would be to require reinstatement of the employer-derived portion only upon reemployment, with no requirement for repayment of the distribution.

Taxation

Taxation of portable pensions should be consistent with other taxation of pension plans. As with IRA rollovers, there would be no tax at the time a transfer is made to the portable pension fund. Payments to participants and beneficiaries would be taxed in the same manner as similar payments from a qualified plan of an employer.

Conclusion

The problems of a federal portable pension fund have feasible solutions. Such a program, made available for voluntary use by private pension plans, would enhance the retirement security of millions of American workers.

Chairman PICKLE. Well, I certainly thank you all.

Let me try to ask a general question. First let me ask Dr. Andrews, if I remember your testimony, and I can't seem to find a copy of it, did you give us a documentation of the number of people who leave their first pension, how many take a lump sum, how many would want to invest in something else?

Ms. ANDREWS. Yes, EBRI figures indicate that approximately 6½ million workers said they received a lump-sum distribution.

Chairman PICKLE. Give me a percentage. Of the average worker how many—5, 10, 20 percent—how many of them follow that procedure?

Ms. ANDREWS. How many save their money?

Chairman PICKLE. Let me put it this way. How many choose to take a lump sum?

Ms. ANDREWS. That we don't know. We have nationwide data on how many workers received lump sum distributions before retirement, but we don't have nationwide data on how many elected to take a lump sum when they could have chosen another type of distribution.

Chairman PICKLE. I am trying to get in my mind under present conditions, when a person leaves his first employer and goes to another, how many of them actually take lump sums?

Ms. ANDREWS. I think I understand your question, but we have no nationwide data on that subject. We don't know how many employees when allowed to choose a term of distribution select a lump-sum payment.

Chairman PICKLE. Among all of you, generally speaking, do most take cash lump sum?

Mr. GRUBBS. When given a choice, the majority take lump sum distributions. The plans I work with, of those plans that have a choice, I would say 95 percent have taken a lump sum distribution in the last 2 years.

Chairman PICKLE. Ninety-five percent or in that neighborhood, most of them do that.

Mr. GRUBBS. Yes. And some plans pay only lump sums and do not allow an annuity at all.

Chairman PICKLE. Mr. Anschutz, ought we to have some kind of penalty if they were to do that.

Mr. ANSCHUTZ. Yes. I think here again access to cash may, in fact, be an incentive for turn over. That is a great way to get your hands on money which had some tax protection as an encouragement to provide for your own old age.

I am not sure we would take a hard-nosed position at this point that there should be absolutely no opportunity for distribution. But generally, distribution for purposes other than the purpose under which you grant a tax benefit and one which makes these people more likely to become public charges, when, in fact, you provided them with an opportunity to take care of themselves, seems to us to be a conflict of policies in which some of the rules for operating this system tend to be at odds with the objectives of the pension system. So we would say—make it more difficult for people to withdraw and cash out a pension fund.

Chairman PICKLE. I believe most of you recommend some kind of a roll over or some kind of a vehicle to have a choice.

Mr. ANSCHUTZ. Another possibility would be, as suggested here a central federal fund. If, as some people fear, that fund would become so large it would have adverse effects on the financial market, there could be the creation of smaller funds under the jurisdiction of banks or insurance companies if they were under proper fiduciary rules and development policies.

Chairman PICKLE. Do all of you feel that we ought to have some kind of specific instruction, if not mandatory, when an employee wants to leave that company, that he be given options what his choices are, what he can do? Should that be required?

Mr. GRUBBS. Sir, I believe there should not be a requirement that lump sums be paid out of plans. The best way to preserve a person's pension is to preserve it in the plan as an annuity. That does preserve it. One of the plans I recently did a valuation of, there was a gentleman 97, retired 32 years ago, he is still receiving his monthly pension and, in fact, the monthly pension he is receiving from that defined benefit plan is double what it was originally because, like many employers, this employer had given increases after retirement to ameliorate cost of living increases after retirement.

This cannot happen when the person cashes out. We ought to encourage preservation of pensions in the plan. But if the plan is going to make a pay out, we need to have better facilities to have that benefit rolled over and preserved.

Mr. ANSCHUTZ. Excuse me, I understand your question to be if a person left employment, should the employer be required to give him a statement of his rights to do certain things. Was that the question? Was that implied in your question?

Chairman PICKLE. I didn't get your question, I am sorry. What communication?

Mr. ANSCHUTZ. You previously asked the question, should the employer be required to give an employee an explanation of his rights at a time he leaves. My own experience as a retirement administrator leads me to say that by all means an employee should understand those rights.

I think the reason for the large percentage of withdrawals and cash outs is because the individual doesn't understand the implications of roll overs and the tax consequences of that kind of change. And so the easy solution is to take the money and cash it out.

Chairman PICKLE. Do we have any statistics to show if an individual does cash out, what he does with that money?

Ms. ANDREWS. Yes, we do. Most people who cashed out lump sum distributions, did not save those funds. They used them for current consumption instead. We conducted a survey in 1983, and we have just fielded another one in 1988 through the Census Bureau. We will know next year whether those figures have changed.

Chairman PICKLE. All right. I thank you, very much.

Mr. Anthony.

Mr. ANTHONY. I would like to ask the members of the panel to comment on a statement a witness previously made regarding the Department of Labor. He talked about the good things but then talked about the bad things. One of the bad repercussions was forcing the loss of jobs. Yet, another witness stated, and I think this is the witness for Treasury, stated one reason the plans differed is be-

cause sometimes they tend to encourage more qualified employees, maybe it was a company that was highly technical.

To what extent would you support employers being able to utilize the pension plans for those type of policy reasons; in other words, use the defined benefit plans to penalize the short-term employees in favor of the long-term employees? Is that good or bad public social policy?

Ms. Moss. I think employers have always been inclined to use pension plans as management tools to encourage a certain employee to stay as long as possible.

The question is, as long as taxpayers are going to be subsidizing this retirement system there is a point at which a pension cannot just be a reward for a certain kind of employee. It has to be fair to all employees, and I think that is the hard job of Congress, trying to balance the employer's desire to make it a management tool with basic pension equity for employees.

Mr. ANTHONY. Dr. Andrews.

Ms. ANDREWS. I think that that is very true indeed. What you have is a continuum of policies and where we are on the continuum now are policies that are market oriented and work through the tax system.

Those policies will not distribute benefits equally but they do have the advantage of working with the employer, encouraging productivity and essentially encouraging economic efficiency.

If you go to a mandatory approach, you require all the benefits to be the same, but you don't have the types of positive productivity effects that you do in a voluntary system and one of those productivity effects is that pensions are used as a manager tool to encourage workers to stay longer because employers who have highly qualified workers need them to stay longer in order to get the best out of the investment and the training these workers have.

Mr. ANTHONY. Let me skip over Mr. Anschutz, because I have a second question I want to ask you.

Mr. Grubbs, do you have a comment on this?

Mr. GRUBBS. Yes, sir. Employers adopt plans for many of their own business objectives, attracting employees, trying to raise morale, sometimes to provide benefits for the owner himself in the small business.

But the plans are required to be nondiscriminatory under laws and rules that are working pretty well and the result is whatever motivation the employer has there are broadly provided benefits that are working fairly well.

Mr. ANTHONY. The second question I would like to have addressed to you, Mr. Anschutz, is if you had a choice between using additional tax incentives to further encourage pension coverage or expand Medicare and social security benefits, what would you choose or your association choose? If you can address those two questions.

Mr. ANSCHUTZ. I am not sure I am competent to say either or because both of these issues are of tremendous concern. We have been characterized from time to time as being selfish old grinches concerned only about what happens to us I would like to say our concern with portability is one issue on which we subscribe to the intergenerational process in which societies have survived so long

as each generation acknowledges not only its indebtedness to those who went before, but its obligation to provide also for those who come after it.

I would not feel confident to say either or. I think we have to find some balance between both of those objectives and I hope as this work progresses you will find us in a constructive and responsible way responding to your question in terms of the specifics of legislative proposals on both issues.

Mr. ANTHONY [presiding]. Do you have any further questions, Mr. Schulze?

Mr. SCHULZE. No I do not. I would like to thank the panel for a very cogent presentation.

Mr. ANTHONY. Our next panel consists of four individuals, Alan V. Reuther, associate general counsel, United Automobile, Aerospace & Agricultural Implement Workers of America; Edward C. Bertnolli, chairman, United States Activities Board, Institute of Electrical and Electronics Engineers, Inc.; Richard H. Fay, Esq., Reed, Smith, Shaw & McClay, National Association of Manufacturers; and David Wray, president, Profit Sharing Council of America.

You heard Chairman Pickle's previous announcement that your entire statement will be make a part of the record, and you are permitted at this point to proceed as you may wish.

We will recognize each of the witnesses in the order in which they were called.

Mr. Reuther.

STATEMENT OF ALAN V. REUTHER, ASSOCIATE GENERAL COUNSEL, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA [UAW]

Mr. REUTHER. My name is Alan Reuther, associate general counsel for the International Union, UAW. The UAW appreciates the opportunity to testify before this subcommittee concerning the subject of pension portability.

Any discussion of pension portability should begin with the recognition that Congress has already established a system for providing a mimimum level of retirement income to workers and their families that provides almost universal coverage for the private work force and which also has the advantage of complete portability. That system is Social Security. Due in large part to these attributes, Social Security remains and must continue to remain the bedrock upon which retirement income security is built.

In contrast, even though more than half the workers in the private sector are now covered under pension plans, many of them will receive little or no retirement income because of vesting standards and frequent job changes. Thus it is apparent the private pension system cannot serve as a substitute for Social Security.

Social Security is also superior to individual savings arrangements such as IRA's. Even when IRA's were theoretically available as a retirement vehicle for all citizens, data revealed the actual usage of IRA's was skewed to higher income individuals. In recent years there have been a number of proposals, such as the proposal

advocated by Pat Choate, which would require all employers to provide some form of defined contribution plan.

Although well-intentioned, the UAW believes these and other similar proposals are misguided. If Congress should decide there is a need to improve the minimum level of retirement income available to all Americans, the best approach would be to improve the benefits provided under Social Security, not to create an entirely new separate mandatory private pension system.

We do believe, however, that a number of steps can be taken to improve pension portability within the framework of a voluntary private pension system. The UAW strongly supported the provisions in the Tax Reform Act of 1986 which lowered the vesting standard for single employer defined benefit pension plans from 10 to 5 years. This should reduce the number of workers who will forfeit pension benefits because of frequent job changes.

However, shortening the vesting standard by itself cannot completely solve the problem of pension portability. Workers who are forced to change jobs before the completion of 5 years still may forfeit their accrued pension benefits.

More importantly, even workers who satisfy the vesting standard will still only qualify for a pension benefit that is fixed in amount at the time employment is terminated. Their pension benefits will then suffer from steadily eroding purchasing power.

These problems can be addressed in a number of ways. First, the Federal Government should take steps to facilitate the portability of pension credits between employers, especially employers within the same industry. For example, the Federal Government could make participation in a pension portability program a condition of receiving major Government defense contracts such as in the aerospace industry.

Second, the UAW believes the Federal Government should explore the feasibility of issuing purchasing power or index bonds, bonds which protect investors against erosion of interest and principal due to inflation. In our judgment, these would represent an attractive option for many pension plans and could provide a mechanism for protecting retirees against the risk of having their income eroded by inflation. The UAW urges the subcommittee to consider legislation requiring the Secretary of the Treasury to conduct a study on the feasibility of issuing such index bonds.

The aspect of pension portability which has received the most attention in recent years has been the portability of the current values of vested benefits—that is the extent to which deferred vested pension benefits are distributed to workers in the form of lump-sum cash payments and the extent to which these lump-sum cash payments are reinvested in other retirement plans or accounts.

The Tax Reform Act of 1986 sought to discourage lump-sum cash distributions by imposing a 10 percent excise tax on early withdrawals from pension plans. More recently, a number of bills have been introduced which would take additional steps to either discourage lump-sum cash payments or to facilitate the transfer of such payments to other tax deferred retirement plans—H.R. 1961 and H.R. 1992, for example.

Although we support the general policy underlying these proposals, we believe they all require further refinement. Most importantly, we must not lose sight of the fact none of these proposals even purport to address the fundamental problem of pension portability, that is providing some mechanism for workers to carry their credited service from job to job or, in the alternative, providing some mechanism for post-termination indexing of pension benefits.

In conclusion, we look forward to working with the members of the subcommittee in the development of workable solutions to the difficult issues associated with providing true pension portability.

Thank you.

Mr. ANTHONY. Thank you very much.

[The statement of Alan V. Reuther follows:]

STATEMENT OF ALAN V. REUTHER, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

Mr. Chairman, I am Alan V. Reuther, Associate General Counsel for the International Union, United Automobile, Aerospace & Agricultural Implement Workers of America (UAW). The UAW appreciates the opportunity to testify before this Subcommittee concerning the subject of pension portability. This subject is of vital concern to the 1.5 million active and retired members of the UAW, most of whom are covered under negotiated defined benefit pension plans.

Broadly defined, the term "pension portability" means the ability to maintain pension benefits upon a change in employment. "Portability" involves three components: vesting standards, credited service, and the current values of vested benefits.

In recent years, there has been a growing interest among Members of Congress, economists, and persons associated with the private pension community in the subject of pension portability. The lack of portability adversely affects the adequacy of retirement income. It also dampens the mobility of the workforce, and ultimately weakens the competitiveness of American firms. Because of these concerns, the UAW strongly supports measures which would enhance pension portability.

Social Security

Any discussion of pension portability should begin with the recognition that Congress has already established a system for providing a minimum level of retirement income to workers and their families that provides almost universal coverage for the private workforce, and which also has the advantage of complete portability. That system is Social Security.

More specifically, it is important to note that most persons with any significant attachment to the workforce will become "vested" under Social Security. Social Security also provides for complete portability of credited service when workers move from job to job. Since Social Security only pays benefits in the form of a lifetime annuity (as opposed to lump-sum cash payments), the current value of "vested" benefits is retained for retirement income purposes. In addition, the purchasing power of these retirement benefits is fully protected, since Social Security benefits are indexed to the cost-of-living.

Due in large part to these attributes, Social Security remains the bedrock upon which retirement income security is built. Two-thirds of the over-65 population relies on Social Security for more than one-half of their income; a third of this age group rely on Social Security for more than 90 percent of their income.

In contrast, although the private pension system has grown tremendously since the end of World War II, nevertheless only about one-third of the population over 65 receives benefits from a private pension plan. Even though more than half of the workers in the private sector are now covered under pension plans, many of them will receive little or no retirement income because of vesting standards and frequent job changes. Thus, it is apparent that the private pension system cannot serve as a substitute for Social Security.

Social Security is also superior to individual savings arrangements, such as Individual Retirement Accounts (IRAs). Prior to the changes in the Tax Reform Act of 1986, IRAs were theoretically available as a "retirement" vehicle for all citizens. In practice, however, the data revealed that the actual usage of IRAs was heavily skewed to upper income individuals. In addition, individuals were contributing to IRAs primarily to take advantage of the tax deduction, not to augment their retirement income. With the restrictions contained in the Tax Reform Act of 1986, it is even more apparent that IRAs cannot form the basis for a universal, portable retirement income system.

Since Social Security is superior to private pension plans and individual savings arrangements in terms of providing universal coverage and portable pension benefits, the UAW believes it is imperative that the Social Security program be preserved and

expanded. In particular, we are opposed to any curtailment in the automatic cost-of-living adjustments (COLAs). Any tampering with Social Security COLAs will only serve to undermine one of the key components of "portability" under the Social Security system -- that is, providing retirees with protection against inflation.

In recent years, there have been a number of proposals to require all employers to contribute to some form of defined contribution pension plan. The 1981 President's Commission on Pension Policy recommended the establishment of a mandatory Minimum Universal Pension System (MUPS). More recently, Pat Choate has advocated that employers and employees be required to contribute to a "Portable Pension Plan" administered by the federal government, in situations where they are not otherwise covered under an employer-sponsored pension plan.

Although well-intentioned, the UAW believes that these and other similar proposals are misguided. We believe that defined contribution plans are not the best vehicle for providing an adequate level of retirement income to workers and their families. More importantly, since Social Security already constitutes a mandatory retirement system financed through employer-employee contributions, there is no reason to create a separate system based on these same principles. If Congress should decide that there is a need to improve the minimum level of retirement income available to all Americans, the best approach would simply be to improve the benefits provided under Social Security -- not to create an entirely new, mandatory private pension system.

Voluntary Private Pensions

The UAW believes that a number of steps can be taken to improve pension portability within the framework of a voluntary private pension system.

A). Vesting Standards

The UAW strongly supported the provisions in the Tax Reform Act of 1986 which lowered the vesting standard for single-employer defined benefit pension plans from ten to five years. This provision will become generally effective for plan years beginning after January 1, 1989.

In our judgment, this change was long overdue. The shorter vesting standard is an appropriate response to the increased mobility of the workforce. It should reduce the number of workers -- especially women and minorities -- who will forfeit accrued pension benefits because of frequent job changes.

B). Portability of Credited Service (Post-Termination Indexing)

Shortening the vesting standard, by itself, cannot completely solve the problem of pension portability. Workers who are forced to change jobs before the completion of five years still may forefeit their accrued pension benefits. More importantly, even workers who satisfy the new vesting standard will still only qualify for a pension benefit that is fixed in amount at the time employment is terminated. Their pension benefits will then suffer from steadily eroding purchasing power. Thus, more liberal vesting without benefit improvements subsequent to termination (i.e., some form of post-termination indexing) is of rather limited value. Although more workers will qualify for benefits, those benefits will be based on frozen amounts for short periods of service. Thus, even with more liberal vesting, workers who change jobs a number of times during their career will still receive a significantly lower pension benefit than workers who stay with the same employer.

This can be illustrated by the following example. Suppose two workers are covered under defined benefit pension plans throughout their working careers (40 years). The pension plans all provide benefits based on 1% of final pay times the worker's years of credited service. If the first employee worked for the same employer for the entire 40 years, the employee's pension benefit would be based on 40% of the worker's final

pay at the time of retirement. In contrast, if the second employee worked five years for eight different employers, although that employee would be entitled to deferred vested pension benefits from each of the eight employers, the sum total of these benefits would be considerably less than the total pension benefit provided to the first employee. This is because the second employee's deferred vested pension benefits will all be based on the final pay at the time the employee terminated employment with each employer -- not on the final pay at the time the employee retires. Stated another way, the second employee will receive a much lower pension because there is no requirement that the deferred vested pension benefits be indexed to reflect increases in wages and the cost-of-living.

These inter-related problems -- the ability to carry credited service from job to job, and the indexing of pension benefits after termination of employment -- can be addressed in a number of ways. First, the federal government can take steps to facilitate the portability of pension credits between employers. We recognize that the development of such a program will have to address difficult issues associated with eligibility, benefit levels, funding mechanisms and administration. But these are not insurmountable tasks. This type of "portability" of pension credits already exists in multi-employer pension plans. The federal government could encourage the development of similar programs within various industries. For example, the UAW has already proposed such a program to several employers in the aerospace industry. The federal government could make participation in a pension portability program a condition of receiving government defense contracts.

Second, the UAW believes the federal government should explore the feasibility of issuing "purchasing power" or "index" bonds -- that is, bonds which fully protect investors against erosion of interest and principal due to inflation. An article by Alicia Munnell and Joseph Grolnic in the September/October 1986 issue of the New England Economic Review suggests that these types of bonds would represent an attractive option for many pension plans and individual retirees, and could provide a mechanism for protecting retirees against the risk of having their income eroded by inflation. According to the authors, these types of "index" bonds could be issued by the federal government without disrupting the financial markets or substantially affecting federal budget financing. The UAW urges this Subcommittee to consider legislation requiring the Secretary of the Treasury to conduct a study on the feasibility of issuing such "index" bonds.

C). Portability of the Current Value of Vested Benefits

The aspect of pension portability which has received the most attention in recent years has been the portability of the current value of vested benefits. This concept basically refers to the extent to which deferred vested pension benefits are distributed to workers in the form of lump-sum cash payments (as opposed to life time annuities), and the extent to which these lump-sum cash payments are reinvested in tax-preferred retirement plans or accounts (as opposed to being spent for non-retirement purposes).

There are two major policy reasons for discouraging the distribution of pension benefits in the form of lump-sum cash payments and the use of these lump-sum payments for non-retirement purposes. First, this practice obviously tends to undermine the overall adequacy of retirement income benefits. Second, it violates the original premise underlying the granting of tax preferences to pension plans -- that is to encourage savings for retirement income purposes. If Congress wants to provide tax preferences for other types of savings (i.e., savings for college education, medical expenses, etc.), it can directly sanction these types of savings arrangements. To date, however, Congress has not chosen to do this; it has simply provided for tax-preferred savings for retirement income purposes. Accordingly, monies accumulated on a tax-preferred basis in retirement plans should not be allowed to be used for non-retirement purposes.

The Tax Reform Act of 1986 sought to discourage lump-sum cash distributions by imposing a 10 percent excise tax on early withdrawals from pension plans which are

not paid in the form of an annuity. More recently, a number of bills have been introduced which would take additional steps either to discourage lump-sum cash payments and/or to facilitate the transfer of such payments to other tax-preferred retirement plans or IRAs. See: the "Pension Portability Act of 1987" (H.R. 1961; S. 944) (Jeffords/Quayle); the "Portable Pension Plan Act of 1987" (H.R. 1992) (Feighan/Matsui); and the "Pension Portability Improvement Act" (H.R. 2643; S. 1349) (Chandler/McCain).

Although the UAW supports the general policy underlying these proposals, we believe they all require further refinement. We would caution that such proposals may not be well received by many workers, who may view these types of restrictions as limiting their flexibility and amounting to an indirect tax increase. Most importantly, the UAW believes it is important to keep in mind that none of these proposals even purport to address the fundamental problem of pension portability discussed in the previous section -- that is, providing some mechanism for workers to carry their credited service from job to job, or in the alternative, providing some mechanism for post-termination indexing of pension benefits.

Conclusion

The UAW appreciates the opportunity to share its views on the subject of pension portability with the Subcommittee. We believe this is an important subject which needs to be addressed by Congress in the coming years. We look forward to working with the Members of the Subcommittee in the development of workable solutions to the difficult issues associated with providing true pension portability.

Thank you.

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Mr. ANTHONY. Mr. Bertnolli.

STATEMENT OF EDWARD C. BERTNOLLI, CHAIRMAN, U.S. ACTIVITIES BOARD, INSTITUTE OF ELECTRICAL AND ELECTRONICS ENGINEERS, INC.

Mr. BERTNOLLI. Mr. Chairman and members of the subcommittee, I am Dr. Edward Bertnolli of St. Louis, Mo. Jobwise I am a professor of electrical engineering with the University of Missouri, and I manage their graduate programs in St. Louis, supporting we hope future competitiveness of all important companies in St. Louis that are headquartered there.

Volunteerwise, I am the Institute of Electrical and Electronics Engineers' vice president for professional activities and chairman of our United States Activities Board.

Our testimony today has been endorsed by the following organizations. The American Association of Engineering Societies, the American Institute of Chemists, the American Society of Civil Engineers, the Public Affairs Council of the American Society of Mechanical Engineers, the Engineers and Scientists Joint Committee on Pensions, and the National Society of Professional Engineers.

In total, these groups represent about 1½ million engineers and scientists.

Let me say that I am an electrical engineer, and that pensions are outside my primary area of expertise. However, our training and our daily job practice is highly mathematical, so to us, actuarial type calculations are ordinary and maybe even simple.

In my volunteer professional society capacity I conduct meetings throughout the United States. We try to get our members' opinions so we can represent them on important issues. I must say that pensions and the work you are doing here is very important because all of our discussions eventually get down to pensions. I attended one in Mr. Anthony's State last fall in a place called Little Rock, Ark., and again it got to pensions.

So public interest in pensions is very great and broad, and not related just to engineers.

We have three things we would like to have you consider. One is the expansion of coverage of the pension system. We are concerned that nearly half of all working Americans are still not covered by employer-sponsored plans.

Our view is that simplified employee pensions hold the most promise as a means of expanding coverage, particularly among workers employed by small companies, which we have a lot of today.

Congress can help by giving small business financial and administrative incentives to offer employer-funded SEP's on a salary reduction basis.

We would also like to promote individual savings which in the composite increases overall U.S. savings.

We are concerned that the present law makes it difficult for very many middle-income Americans to build up supplemental retirement nest eggs through their own personal savings.

Private pensions and social security, after all, currently replace less than half of the typical worker's pre-retirement earnings.

Enactment of legislation that will permit workers who change jobs before vesting in an employer-sponsored pension plan to take an income tax deduction for amounts that they contribute to an individual retirement account during the pre-vesting period would be very helpful. I am talking about people who are covered but not vested in employer-sponsored pension plans.

In the interest of equity, we also recommend that the IRA tax deduction limit for nonvested workers be set at $7,000 as opposed to $2,000. We think $7,000 is a more appropriate number.

Finally, with respect to pension portability, we are particularly concerned about the importance of preserving the purchasing power of pension benefits when workers change jobs.

We recommend that terminating employees be permitted to roll their accrued invested benefits over into another tax-deferred retirement arrangement or to leave their benefits in their former employer's plan.

The rollover value of such benefits should be calculated using a deflated long-term interest rate rather than the prevailing market interest rate.

This historically turns out to be about 3 percent and gives a better retirement income. Accrued vested benefits that are left in the former employer's plan from job termination until retirement should be indexed to help maintain their purchasing power.

About 2 years ago, I wrote a short paper which had a number of calculations in it on the impact of changing jobs on pension benefits.

I titled it "The Impact of Pensions on Career Change" or "Can I Really Afford that New and Better Job?"

The contents of that paper apply to engineers or anyone else with a good salary model from which to work through a lifetime.

I am an electrical engineer. If I were to change jobs at my present age—I am 52—and my new employer had an identical plan, I would require an 85-percent salary increase in order to get the same retirement benefits at age 65.

Thank you very much.

I will be happy to answer any questions that you may have.

Thank you.

Mr. ANTHONY. Thank you.

[The statement of Mr. Bertnolli follows:]

TESTIMONY ON PENSION PORTABILITY

by

EDWARD C. BERTNOLLI
CHAIRMAN, UNITED STATES ACTIVITIES BOARD
INSTITUTE OF ELECTRICAL AND ELECTRONICS ENGINEERS, INC.

Mr. Chairman and members of the Subcommittee, I am Edward C. Bertnolli of St. Louis, Missouri. I am Director of the Graduate Engineering Center and Professor of Electrical Engineering at the University of Missouri-Rolla. In this capacity I administer the University's Master of Science Programs in nine engineering disciplines plus computer science and serve as the principal liaison between the Center and supporting companies and agencies in the metropolitan St. Louis area. I am also the Vice President of Professional Activities for the Institute of Electrical and Electronics Engineers, Inc. (IEEE) and Chairman of IEEE's United States Activities Board.

I sincerely appreciate this opportunity to testify at these hearings and to communicate the views, not only of IEEE members, but also those of the members of six other major scientific and engineering organizations on the need for further improvements in the nation's voluntary private pension system.

In this connection I'm pleased to report that IEEE's written statement has been formally endorsed by the following national organizations: The American Association of Engineering Societies (AAES), The American Institute of Chemists (AIC), The American Society of Civil Engineers (ASCE); the Council on Public Affairs of the American Society of Mechanical Engineers (ASME), the Engineers and Scientists Joint Committee on Pensions (ESJCP) and The National Society of Professional Engineers (NSPE).

American Association of Engineering Societies (AAES) and Engineers and Scientists Joint Committee on Pensions (ESJCP) are umbrella organizations. The other groups are individual membership organizations. Together we represent more than 1,500,000 engineering and scientific professionals throughout the United States.

Pensions Profile and Current Concerns of IEEE Members

IEEE's membership profile and its members concerns about pensions reflect those of the other organizations that we are representing here today.

The Institute of Electrical and Electronics Engineers, Inc. (IEEE) is comprised of more than 290,000 electrical and electronics engineers and computer specialists, some 235,000 of whom live and work in the United States. Forty percent of its working U.S. members are employed by large corporations. Thirty five percent work for medium sized companies and an additional sixteen percent work for small businesses. Five percent are deans, professors or instructors at schools and colleges of engineering. Four percent are self employed on a full time basis. And six percent work as consultants to business or industry on a full or part time basis.

According to its most recent Salary and Fringe Benefits Survey, eighty-one percent of IEEE's U.S. members are covered by but not necessarily vested in pension plans offered by their employers (many of these are final average defined benefit plans). I say covered but not necessarily vested because the typical engineer changes jobs fairly frequently and is likely to have 3 or 4 employers over the course of his or her career. One third of the IEEE members whose employers offer pension plans are currently covered by plans that vest after 5 years. Even with the recent reduction of vesting standards from 10 to between 5 and 7 years, many of our mobile members will not vest in an employer sponsored pension plan.

Because of our members longstanding concerns about the extent to which the nation's voluntary pension system discriminates against mobile workers, IEEE/USAB and the other organizations that have endorsed our statement are dedicated to improving the retirement income benefits that are available to scientific and engineering professionals. To this end our organizations have worked since the early 1970's to encourage the development of employer sponsored pension and savings plans that will provide a greater measure of financial security for all Americans during their retirement years. Our organizations actively supported passage of the Employee Retirement Income Security Act (ERISA) in 1974, the Individual Retirement Arrangements (IRA) provisions of the Economic Recovery Tax Act (ERTA) in 1981, and the retirement equity (coverage, vesting, and integration) provisions of the Tax Reform Act of 1986.

In spite of major improvements in the nation's private pension and retirement savings system that have resulted from these legislative milestones, a number of deficiencies continue to limit the system's adequacy as a reliable source of adequate retirement income for many Americans.

We are concerned that about half of all working Americans, including many engineers and scientists, are not covered by an employer sponsored pension plan. Others who are covered will not collect any benefits at retirement and many of those who do will collect much less than they need to maintain a reasonable standard of living.

We are also concerned that America's private pension system discriminates against mobile workers and about the extent to which the system fails to meet the needs of those who are employed by small businesses.

We have also found that present law makes it difficult for very many Americans to build up supplemental retirement savings through their own self-thrift. It is no longer certain that a middle income worker in the private sector who is covered by a private pension plan and Social Security will be able to retire with an income sufficient to maintain his or her pre-retirement living standard. Even long tenured workers may find that the combination of a private benefit and Social Security is inadequate to meet their needs. These two sources, after all, currently replace less than 50% of the typical worker's pre-retirement earnings. Individual savings for retirement must be made a more important supplement to Social Security and private pension benefits.

We think it is essential that Congress move quickly to enact additional legislative incentives and mechanisms to encourage the establishment of a more flexible retirement system including employer sponsored plans and individual retirement income arrangements that will more adequately meet the needs of an increasingly mobile workforce in an increasingly competitive international economy.

The form and scope of such initiatives are a matter of considerable interest to our 1.5 million members who are involved in almost every aspect of American business and industry. Many are employed in the dynamic aerospace and defense electronics industry where contracts, projects and companies expand and contract, seemingly overnight, and where job changes are frequent and vested pension benefits are hard to come by. Another substantial segment of our members are employed in more stable industries, such as electric power and telecommunications, where long term service has traditionally been the norm. But even among these companies, pension problems have begun to surface. The recent rash of business takeovers, mergers, consolidations, and corporate downsizings has created unsettling situations which have dimmed the prospects of a secure retirement for many engineers and scientists.

A substantial number of our members are leaving the ranks of corporate employment to start small businesses of their own or to work as consultants or independent contractors. Such individuals must provide for their own retirement needs and possibly those of a handful of employees.

As you can see ours is a very diverse group of professional and technical personnel. Because of this diversity, our interests in and concerns about pension issues are also very broad-based. But today I would like to focus on three issues of substantial consequence to everyone in the American workforce. As we see it, the major challenge facing the Congress and America's voluntary private pension system is to find ways to expand pension coverage, particularly among small businesses; to promote increased savings by individuals for retirement purposes; and to improve pension portability. With respect to pension portability, we are particularly concerned about the importance of preserving the purchasing power of pension benefits when workers change jobs.

Expansion of Pension Coverage

First, we see an urgent need to extend coverage to the substantial numbers of Americans whose employers do not currently offer pension benefits. We are concerned that after at least two decades of steady gains, coverage has leveled off at around 50%, and now seems to be declining. This topping out appears to coincide with the emergence of small business as the principal creator of new

jobs. Current data from the Census Bureau indicates that less than 35% of the individuals who work for firms with fewer than 100 employees participate in any kind of pension plan and that less than 10% of the workers who are covered are likely to vest and thereby become entitled to future benefits.

If retirement plan coverage is to be extended significantly, it will have to be primarily among small firms.

In our view, Simplified Employee Pension Plans (SEPs) hold the most promise for expanding pension coverage among workers in small companies. Small businesses should be given financial and administrative incentives to offer employer funded SEPs, and, in addition, be required to offer SEPs on a salary reduction basis when no other company retirement savings vehicle is available.

Increased Incentives for Individual Retirement Savings

Second, we urge Congress to take a long-term view with regard to the tax treatment of individual retirement savings arrangements, and to enact legislation that will permit persons who change jobs before vesting in a pension plan to take an income tax deduction for amounts contributed to an IRA during the pre-vesting period.

Because the average tenure in today's mobile workforce has dropped to about 6 years, and continues to fall, a large percentage of covered workers never vest and never collect retirement benefits from any employer.

We believe the current system discriminates against short-tenured workers since they do not have access to retirement vehicles with the same kinds of tax advantages that are provided under tax-qualified pension plans.

In our view the previous and still current $2,000 per year limit on tax deductibility for IRA contributions will not provide an adequate retirement income for very many middle income workers. In the interest of equity, we also recommend that the IRA tax deduction limit for non-vested workers be set at a level consistent with qualified salary reduction plans, i.e. at $7,000.

Such a change would assist that segment of the workforce that hasn't vested. But what can be done to preserve the pension benefits of workers who change jobs after vesting in an employer sponsored plan?

Improving Pension Portability

Under current law, when a vested employee leaves a company before retirement there are two possible outcomes: either the actuarial present value of the employee's accrued benefits is distributed as a lump sum at the time of his or her departure or the monies representing earned benefits are retained by the plan for distribution when the vested employee reaches retirement age.

There is ample evidence that lump sum distributions received early in workers careers are frequently spent rather than saved for retirement, particularly the smaller amounts typically received by short tenured workers. And benefits that are kept in a former employer's defined benefit plan lose purchasing power over time due to the adverse effects of inflation. Even though inflation is no longer in the double digit range, it still remains sufficiently high to erode the purchasing power of pension benefits. Assuming that the current 4% inflation rate continues, a forty year old worker who changes jobs today will receive a pension benefit from his former employer when he reaches retirement age that has a real value of less than 40 cents on the dollar. In other words, inflation will reduce the purchasing power of the worker's retirement benefits by more than 60 percent.

Our 1.5 million members think that this is unacceptable. To the extent that pensions represent deferred wages, it can be argued that employees pay for their retirement benefits by accepting lower wages and should be entitled to receive the equivalent purchasing power at retirement.

This is not a radical notion. It is entirely consistent with the widely held conviction that benefits received during one's retirement years ought to keep pace with inflation. Social Security and most government sponsored pension plans subscribe to this viewpoint and index payouts. Isn't the concept of preserving the purchasing power of pre-retirement accumulations an equally valid concept?

To ensure that pension benefits remain intact when workers change jobs, several changes to present law are required. First, we recommend that lump sum cash outs of accrued benefits should be discouraged when employees change jobs. Instead, terminating employees in all pension plans should be given the option of choosing a rollover into some form of tax-deferred retirement arrangement, or of leaving the benefits in the former employer's plan, if the value exceeds some minimum amount, say $3500.

In keeping with the principle that pension benefits represent deferred wages whose purchasing power is to be maintained, we also recommend that the roll-over value of benefits accrued under defined benefit plans should be calculated on the basis of a deflated long-term interest rate of about 3% rather than an actuarial rate derived from market rates. This would provide true pension portability by defining and specifying the monetary value to be attached to the employer's promise when a vested employee leaves prior to retirement. True portability is achieved when there is a reasonable expectation that the purchasing power of accrued vested benefits will be maintained from the time of termination until the worker reaches normal retirement age. This condition is likely to be achieved when the rollover value is computed using a deflated interest rate and transferred funds are then invested at market rates.

In keeping with the principle of maintaining purchasing power we also recommend that accrued vested benefits that are left in a former employer's defined benefit plan from the time of job termination until retirement be indexed to maintain their purchasing power. This could be accomplished either by means of performance indexing wherein investments above a statutory real rate of return would be used to enhance pension benefits or through the use of index bonds whose nominal yield incorporates an inflation premium.

The present value of both rollover and retained job termination benefits in a defined benefit plan should be assized on the basis of the most valuable form of accrued benefits that would otherwise be available. The present value of transfers from defined contribution plans should be the combined account balance at the time of separation from service, in other words, the employer's and the employee's contributions plus investment earnings on both.

Another change to current law that is needed to achieve portability is to permit after-tax employee contributions to be added to before-tax contributions in roll-over retirement arrangements.

None of the above recommendations are new proposals, but they are needed now to give real meaning to the concept of pension portability and to remove a serious impediment to the kind of labor force mobility that is needed to maintain America's industrial and economic competitiveness.

We note with some concern that at least two of the pending portability proposals (HR 1992 and HR 2643) would require that every pension distribution be in the form of an annuity. We understand the intent behind these provisions but we believe that the potential for creating hardships in emergency situations outweighs the desire to assure long term income security.

One final recommendation. Hardly a week goes by that we don't hear of a troubling situation in which a relatively young vested employee dies leaving his or her survivors to discover that their loved one's pension plan makes no provision for paying benefits unless the participant dies after some threshold age, typically age 55. Congress should take steps to remedy this grievous situation. Vested benefits must be available to survivors should a pension plan participant die at any age before retirement.

Mr. Chairman, this concludes our testimony. I thank you for the opportunity to appear before this distinguished Subcommittee. The IEEE and the other scientific and engineering organizations that have endorsed our statement are dedicated to improving our nation's voluntary private pension system. We have worked to this end since the early 1970s. Although major advances have been made in the intervening years, significant shortcomings remain that need to be corrected. On behalf of our 1.5 million members, we look forward to working with the Congress and other concerned organizations to promote the enactment of legislation to expand pension coverage; encourage increased individual savings for retirement, and help to maintain the purchasing power of pension benefits when workers change jobs.

LIST OF SUPPORTING ORGANIZATIONS
(Washington Area Offices)

American Association of Engineering Societies 415 Second Street, NE Washington, DC 20002 202/546-2237	An umbrella organization whose 14 member societies represent more than 500,000 engineers in business, government and education
American Institute of Chemists 7315 Wisconsin Avenue Bethesda,MD 20814 301/652-2447	A professional membership society representing 7,000 chemists.
American Society of Civil Engineers 1667 K Street, NW Washington, DC 20006 202/785-4454	A professional and technical society representing 104,000 civil engineers.
American Society of Mechanical Engineers 1825 K Street NW Washington, DC 20006 202/785-3756	A professional and technical society made up of 118,000 mechanical engineers.
Engineers and Scientists Joint Committee on Pensions 415 Second Street, NE Washington, DC 20002 202/546-2237	A committee of the Engineering Affairs Council of AAES representing 22 engineering, scientific and technical organizations.
Institute of Electrical and Electronics Engineers, Inc. 1111 Nineteenth Street, NW Washington, DC 20036 202/785-0017	A transnational technical and professional organization with more than 290,000 members in 130 counties including 235,000 U.S. members.
National Society of Professional Engineers 1420 King Street Alexandria, VA 22314 703/684-2800	An individual membership society representing 75,000 Professional Engineers throughout the U.S.

SATATEMENT OF RICHARD H. FAY, PARTNER, REED, SMITH, SHAW & McCLAY, ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS, ACCOMPANIED BY EDWIN GILROY, ASSOCIATE DIRECTOR OF EMPLOYEE BENEFITS

Mr. FAY. I am Richard Fay and I am an attorney with a private law firm testifying today, however, on behalf of the National Association of Manufacturers.

To my left is Edwin Gilroy, the benefit expert for the association.

Portability—a long held, but elusive goal of pension legislation.

In 1965, the report, President's Commission on Private Pensions, which became the framework for ERISA, held that one goal should be a uniform program of portability.

When ERISA was being considered, it was frequently said that without portability, there would be no such thing as pension reform. Still, we don't have much portability today and one of the reasons is because there are great differences of interpretation as to what is meant by the word "portability."

Some would seem to imply that portability should be some sort of system giving employees complete credit for every hour, if not second, that they work with an employer and that somehow those credits should be transferred to any future employer.

As Mr. Reuther testified, we have a system like that and it is called Social Security.

I don't think that the private pension system should be asked to duplicate or compete with the Social Security system.

On the other hand, some people have a more modest definition of portability as being a way of facilitating transfer of vested accrued benefits to another plan when an employee leaves his present employer.

To that extent, NAM supports enhanced portability.

In that regard, we would like to characterize H.R. 1961 as an admirable first step in enhancing portability.

I would particularly like to call to the committee's attention that part of the bill encouraging small employers to establish pensions for their employees on a temporary, ad hoc basis which pensions can be transferred to central depositories, thereby allowing small employers to establish plans at little cost, and with great flexibility.

As to the general concept of portability itself, we would like to state three principles that we urge you to consider.

First, that the private pension system is a voluntary system, and that it is frequently a goal of employers in establishing plans to reward longer term employees.

Second, that there is a need for great flexibility and diversity among employers and industries and that this diversity and flexibility should be encouraged, not stifled.

Third, that frankly, a much more serious problem than portability is coverage.

Coverage of the private pension system seems pretty much to have stalled and there is great need to be more imaginative in encouraging coverage of employees of small employers.

It would be unfortunate if in attempting to try to achieve the El Dorado of portability, we create yet another law discouraging small employers from establishing qualified plans.

Thank you very much.

Mr. ANTHONY. Thank you.

[The statement of Mr. Fay follows:]

Testimony of
Richard H. Fay, Partner
Reed, Smith, Shaw & McClay
on behalf of
National Association of Manufacturers
on
Pension Portability
before the
Subcommittee on Oversight
Ways and Means Committee
U.S. House of Representatives
July 12, 1988

Chairman Pickle and Members of the House Ways and Means Subcomittee on Oversight, I am Richard H. Fay, Partner, Reed, Smith, Shaw and McClay, appearing today in my capacity as a member of the National Association of Manufacturers' Employee Benefits Committee. Accompanying me is Edwin Gilroy, NAM's Associate Director of Employee Benefits.

The NAM commends you Mr. Chairman and members of the Oversight Subcommittee for holding this hearing and providing witnesses the opportunity to discuss the critical issues of adequate pension plan coverage, preservation of pension benefits, and in particular, pension portability.

The NAM is well aware of the problems that currently face our private pension system in these three areas. Lack of adequate pension coverage is of great concern, particularly for small employers' and their employees. Currently, only 25% of workers in companies with less than 100 workers have pension coverage. Given that almost 45% of all wage and salary employees work in companies with fewer than 100 employees, such absence of coverage is disturbing. Equally alarming is the growing trend of terminated workers who choose to spend distributions of vested pension assets, rather than reinvesting such amounts for use at retirement. Continued consumption of such benefits immediately upon receipt will likely lead to a serious shortage of adequate funds for these workers when they finally reach retirement age. Interestingly, many of the problems in the areas of adequate pension coverage and preservation of benefits are directly related to the third area of concern -- pension portability.

By way of example, we have found that a major barrier to adequate pension coverage is the high administrative expenses and start-up costs involved in establishing a pension plan. Many employers can simply not afford to set up and fund a company pension plan. This problem has been exacerbated over the past decade by the endless proliferation of pension legislation which has required constant plan amendments. Increased portability, to the extent it would allow pension asset managers to sponsor and administer pension plans, would help alleviate this problem, particularly for small employers. Regarding preservation of pension benefits for retirement purposes, we find that current law lacks sufficient incentive to encourage employees to save these assets for retirement. Arguably, increased portability would help provide that incentive.

No less important to any discussion of pension portability are the changing demographics of the American workforce. Statistics show that workers today are less likely to remain with one employer throughout their careers and, in fact, may change jobs several times. In light of this trend the subject of pension portability takes on greater significance. As a result, the NAM supports the basic concept of pension portability and we applaud the efforts of Congressman Jeffords (R-VT) and others to address this subject. In doing so, however, we caution Congress to exercise restraint when crafting legislation in this area.

We fear that pension portability, if applied excessively and without regard to employer flexibility, may actually damage the very system it seeks to help.

Pension plans are first and foremost, an employee benefit offered by the sponsoring employer. In general, the intended purpose of offering any employee benefit is to attract and retain quality employees. Similarly, most employee benefits, particularly company-sponsored pension plans, seek to encourage worker longevity and reward long-term service. An employer may not wish to provide comparable retirement benefits for two employees with similar earnings and lengths of service, if one has spent their entire career with that employer while the other has worked at many different jobs. Therefore, while we recognize that an increasingly mobile workforce demands some means of pension portability, we would encourage Congress to consider legislation that accommodates this trend rather than encouraging it.

In addition, true pension portability suggests a nationally uniform system in which workers can move from job to job and not lose accumulated benefits. Undoubtedly, such a system would require that service credits accrued under one employer's pension plan be transferred in full on behalf of the terminating employee to the new employer's plan. Aside from the obvious funding questions such a proposal would raise, (i.e. which employer would be responsible for what portion of the benefit?) the NAM believes that full service credit portability can be achieved only at the expense of both employers and employees alike.

According to the Employee Benefit Research Institute, the American pension system is characterized by a diversity of benefits tailor-made to the specific industry, the company and its employees. In such a system, automatic service credit transfers are difficult to attain, if not altogether impossible. Benefit provisions may vary considerably among plans and contribution rates may differ as well. The practical benefits gained by this diversity include retirement policies that directly enhance the productivity of the company and are appropriate for the financial status of that firm.

In addition, differences in pension plan provisions can better meet the needs of different workers in different locations in planning for their future retirement needs. To impose a system that requires full service credit transfers upon all employers, regardless of their industry, location or employee population, would severly diminish an employer's ability to design a benefits program which effectively meets the needs of both the company and its employees. The NAM believes that portability of this nature, which could result in unforeseen expense and administration, might actually serve to discourage employers from establishing or maintaining pension plans. The end result would actually be less pension coverage for fewer workers.

As stated in our opening remarks, the NAM shares the concern of this subcommittee regarding adequate pension coverage for American workers, preservation of retirement benefits and portability of those benefits. Furthermore, we feel that by addressing the problems associated with pension portability, Congress will simultaneously be addressing many of the problems associated with the other two areas. To that end, we feel that legislation such as H.R. 1961 is an admirable first step.

H.R. 1961 would provide employers, particularly small ones, with a means, through portable pension plans sponsored by plan asset managers, to expand pension coverage for their employees. The legislation also provides an attractive alternative to current law in the treatment of vested, terminated employees. Employers would now be able to

transfer monies into portable pension accounts for these terminated employees, thereby discouraging immediate consumption of these assets and encouraging savings for retirement. The legislation does stop short, however, of imposing excessive restrictions on lump sum distributions, service credit transfers and other areas.

There are those who would argue that in doing so, H.R. 1961 falls significantly short of achieving true pension portability. We disagree. Instead, we feel the sponsors of this legislation recognize the complexities of providing a varied and diverse set of benefits to a rapidly changing workforce. As a result, they have targeted a few specific areas for improvement and refrained from dramatic and restrictive change. At the very least, we feel this represents a refreshing change from past practice and instead indicates a step towards the formation of more responsible pension policy.

Mr. Chairman, we thank you again for the opportunity to present our views to this subcommittee and we look forward to working with you on this important issue.

Mr. ANTHONY. Mr. Wray.

STATEMENT OF DAVID L. WRAY, PRESIDENT, PROFIT SHARING COUNCIL OF AMERICA

Mr. WRAY. Thank you very much.

I am David Wray, president of the Profit Sharing Council of America.

The Profit Sharing Council represents over 1,200 profit-sharing companies with 1.75 million employees throughout the United States.

Thank you for this opportunity to testify.

American business is increasingly recognizing the value of profit sharing.

Studies in the United States and Great Britain have shown that companies with profit sharing outperform non-profit sharing companies.

Further, recent studies show that there is greater work force stability, and resulting employment security, in companies with deferred profit-sharing plans.

These studies show that companies with deferred profit sharing do not have to resort as quickly to layoffs in a down cycle.

Also, there is less voluntary termination at profit-sharing companies.

In addition, the Profit Sharing Research Foundation compared the retirement benefits in large deferred profit-sharing companies and found that their deferred profit sharing provided greater retirement benefits than a typical final average salary-defined benefit plan.

It is no wonder that companies practicing profit sharing have increased from under 200 prior to World War II to over 500,000 today.

The Profit Sharing Council opposes restrictive "pension portability" legislation.

The need for such legislation has not been proven and, more importantly, it would reduce the incentive value of profit sharing.

In the case of deferred profit-sharing plans—which are the vast majority of defined contribution plans, it is not true that plan asset accumulations are increasingly being used for current consumption at job termination.

If anything the Tax Reform Act of 1986, which eliminated 10-year averaging and imposed a 10-percent penalty, appears to have resulted in a trend toward saving.

It is our experience that the 38 percent—28 plus 10 penalty—bite has been a big incentive to defer larger distributions and there is little value in forcing deferral of small ones which will largely be demolished by inflation and administrative fees by retirement.

Further, the study upon which much of the argument for restrictive pension portability legislation is based has severe limitations.

It is based upon data collected prior to TRA 86.

In addition, the questionnaire upon which the study is based anticipated that most distributions would be large, with the result that 84 percent of the respondent's distributions fell in the smallest

category—under $5,000—so that it is impossible to establish the value of the vast preponderance of distributions.

Likewise, when queried about their use of the distributions, 62 percent of the respondents replied "other." So the key questions—how much and how was it used—could only be analyzed in a cursory fashion.

There are two other problems with the study. Since the respondents were not asked for the time period at which the distribution was received, the results represented cumulative life experience rather than current activity and the study was done during a severe economic recession, possibly distorting the responses.

Employers share profits with employees as an incentive for increased productivity.

In order for there to be a productivity bang for the deferred profit sharing buck, the employee must feel ownership of the money.

If an employee, especially a younger employee, learns that the money is not his or hers until 59½, the productivity incentive will be lost.

The 1.75 million employees of the companies in the Profit Sharing Council do not want restrictive pension portability legislation. They want and deserve control of their money.

However, the council does not oppose making it easier for those who wish to continue their distributions in a tax-deferred status.

For example, the council does not object to making it easier to make plan-to-plan rollovers or allowing terminated employees to roll both their pre- and post-tax balances into an IRA.

In conclusion, there is no pension portability problem for deferred profit-sharing plans, where balances are already portable.

Most distributions of any size are being retained voluntarily in tax-deferred status.

Most other distributions are so small that there is little value in keeping them tax deferred.

Further, forcing deferral of all distributions would sacrifice the incentive value of deferred profit sharing—a very high price.

Thank you for this opportunity to testify, I will be happy to answer any questions.

Mr. ANTHONY. Thank you very much, Mr. Wray.

[The statement of Mr. Wray follows:]

Pension Portability Testimony
by the
Profit Sharing Council of America

I am David Wray, President of the Profit Sharing Council of America (PSCA). The Council is a non-profit association which, since 1947, has represented companies that sponsor profit sharing plans. It is dedicated to the task of developing, collecting and communicating profit sharing information, and seeks to encourage the philosophy and practice of sharing profits with employees -- whose efforts make profits possible.

The PSCA represents over 1200 companies who employ over 1.75 million plan participants throughout the United States. PSCA members engage in every type of business activity and all regard profit sharing as a vital factor in their success. They range in size from a family-owned fledgling enterprise to the world's largest retailer. One member has shared profits for over 100 years, while other began only last month. All members depend upon the PSCA to represent and advocate their interests concerning current legislative and regulatory proposals that would affect profit sharing plans.

American business is increasingly recognizing the value of profit sharing. Studies in the United States and Great Britain have shown that companies with profit sharing outperform non-profit sharing companies.[1] Further, research by the Profit Sharing Council of America and Hewitt Associates over the 1973-1986 period found an average 11 percent of plan participants terminated for reasons other than retirement, death, or disability.[2] Compare this figure with the 21.6 percent of workers aged 25 or over who had been in their current job for a year or less in January of 1987.[3] Two recent academic studies also provide support for the greater labor force stability, and the resulting employment security, among companies with deferred profit sharing plans.[4]

In addition, the Profit Sharing Research Foundation compared the retirement benefits in large deferred profit sharing companies and found that deferred profit sharing provided greater retirement benefits than a typical final average salary defined benefit plan.[5] It is no wonder that companies practicing profit sharing have increased from under 200 prior to World War II to over 500,000 today.

It is the view of the Profit Sharing Council of America that restrictive "pension portability" legislation is unnecessary and, more importantly, it will reduce the incentive value of deferred profit sharing.

It has been stated "that pension plan asset accumulations under existing pension plans are increasingly being distributed at job termination or otherwise used for current consumption".[6] This is not the case for deferred profit sharing plans -- which are the vast majority of defined contribution plans. If anything, the passage of the Tax Reform Act of 1986, which eliminated 10-year averaging and imposed a 10 percent penalty on early withdrawals and termination distributions, appears to have resulted in a trend toward savings.

The data gathered by the May 1988 supplement to the Current Population Survey (CPS) will not be available for some time yet. However, the limited evidence from the 1983 CPS supplement, mobility patterns and benefit accrual pattern interactions, company experience, and the evidence for labor force stability among companies with deferred profit sharing suggests that the amounts of distributed pre-retirement lump sums are probably relatively small. This is certainly the experience of members of the Profit Sharing Council where most distributions are small. Only a small percentage of employees who leave a company prior to retirement have balances in excess of $5,000.

In the case of a small distribution, it makes no sense to force a recipient to hold the money in a tax deferred status. Fees for required reporting and other investment services will exceed the earnings on small amounts and eat up the principle. What is left will be substantially devalued by inflation. Recipients of larger amounts tend to be older, better educated, and with higher earning potential. As a result, they generally roll their distributions into IRAs to continue the tax deferred status for their funds and avoid the 10 percent penalty. They need not be forced to save their distributions.

Also, the distributions to terminated employees represent only a small fraction of the total assets in deferred profit sharing plans. For example, a large Council member with cliff vesting distributed only 0.5 percent of the plan assets in pre-retirement termination distributions. Another with immediate full vesting distributes about 5 percent. Overall, pre-retirement termination distributions probably represent between 2 and 3 percent of plan assets.

Unfortunately, the study[7] upon which much of the argument for restrictive "pension portability" legislation is based has limitations which reduce its value in addressing this issue. It is based on data collected prior to the passage of TRA '86. In addition, the questionnaire design anticipated that lump sum distributions would be large -- so the smallest precoded response was "Under $5000". Unfortunately, 84 percent of the actual responses fell into this category, so it was impossible to establish average or median values with any degree of certainty or to identify the underlying distribution of the lump sum values. Likewise, when queried about their use of the lump sums, 62 percent of the respondents indicated "Other". So the key questions -- how much and how was it used -- could only be discussed in a cursory fashion in the analysis. The most recent Current Population Survey has been designed to avoid these problems.

Two other problems were also present in the 1983 study: since the individual was not asked for the time period at which the lump sum was received, the results represented cumulative life experience rather than a measure of current activity. Finally, the 1983 survey was conducted during a period adjacent to a severe economic recession, possibly making the responses atypical of a broader time period.

The facts do not support the need for restrictive "pension portability" legislation.

It is interesting that most of the introduced legislation concerning "pension portability" focuses on defined contribution plans of which deferred profit sharing plans are the vast majority. The intent of this legislation is to prevent distribution from deferred plans or make such distributions as difficult as possible.

However, employers share profits with employees as an incentive for increased employee productivity. In order for there to be a productivity bang for the deferred profit sharing buck, the employee must feel ownership of the money. If the employee, especially a younger employee, learns that the profit sharing distribution to a deferred profit sharing plan is not available until age 59½, that employee will see that this distribution is merely a retirement benefit with no immediate meaning. The productivity incentive will be lost. This incentive has already been reduced by the limitations in the Tax Reform Act of 1986. It is the position of the Profit Sharing Council that this productivity incentive must be preserved if the deferred profit sharing system is to continue.

It should also be noted that employees who are changing jobs are more likely to accumulate benefits in a deferred profit sharing plan than other approaches. Specific contributions are made to an employee's account. This money belongs to the employee. This is important because, as shown in "Job Mobility and Private Pensions" published by the International Foundation of Employee Benefit Plans[8], job mobility has been excluded from traditional benefit accrual measurements in defined benefit plans. As the article says, "In order to get anything meaningful out of the private pension system one has to stay with a single employer most of one's working life." This is not necessarily true for employee who work for companies with deferred profit sharing.

Deferred profit sharing, because it typically involves larger contributions, vests more individuals at earlier points in their careers, and allows lump sum distributions, can be expected to contribute to pre-retirement lump sum distributions in greater proportion than the coverage in the general pension population.

Recent BLS data confirms that there has been little change in the overall job mobility patterns since 1968. Even the median white male still does not reach 10 years of tenure with his current job until after age 45.[9] Mobility is most prevalent among the younger workers, those with the lowest vesting and benefit accrual rates.

Deferred profit sharing needs to be encouraged so that employees, especially those young and mobile, have distributions to take with them when they change employment.

Also, the 1.75 million employees of the companies of the Profit Sharing Council do not want restrictive pension portability legislation. They want control of their money. However, the Profit Sharing Council has no objection to making it easier for terminating participants who wish to continue to defer their distributions to do so. For example, the Council does not object to making it easier to make plan-to-plan rollovers or rollovers into IRAs. The Council supports allowing terminated employees to roll their after-tax, as well as their pre-tax balances, into an IRA. The Council supports repealing the requirement that employers must maintain account balances for terminated employees whenever the amount is over $3500 and the employee has chosen not to take a final distribution at termination.

In conclusion, there is no "pension portability" problem for deferred profit sharing plans. In deferred profit sharing plans account balances are already portable. Distributions of any size are being retained voluntarily in tax deferred status. Most other distributions are so small that there is little value in keeping them tax deferred. Further, the price of forcing deferral of all distributions would be the sacrifice of the incentive value of profit sharing. The Profit Sharing Council of America urges that Congress not enact restrictive "pension portability" legislation.

Thank you for this opportunity to testify. I will be happy to answer any questions.

David L. Wray, President
Profit Sharing Council of America

Footnotes

1. Bell, D. Wallace and Charles J. Hanson. 1987. Profit Sharing and Profitability. London: Kogan Page Limited.

   Howard, Bion B. 1979. A Study of the Financial Significance of Profit Sharing. Chicago IL: Profit Sharing Council of America.

2. Profit Sharing Council of America (with Hewitt Associates). Profit Sharing Survey. Chicago IL: Profit Sharing Council of America (various years).

3. Bureau of Labor Statistics. 1987. Most occupational changes are voluntary. BLS News Release. Thursday, October 22, 1987. Table 4.

4. Douglas L. Kruse. 1987. Profit sharing and employment, variability: microeconomic evidence. Mimeo: Department of Economics, Harvard University. Robert S. Smith. 1988. Profit Sharing and Layoffs: An Exploratory Study. Mimeo: NY State School of Industrial and Labor Relations, Cornell University.

5. Metzger, Bert L. 1978. Profit Sharing in 38 Large Companies (Vol. II). Evanston IL: Profit Sharing Research Foundation.

6. Representative James M. Jeffords. 1988 Session of Congress. "Amendment to Subcommittee Reconciliation Proposal." Sec. 3102. Findings and Declaration of Policy.

7. G. Laurence Atkins. 1986. Spend It or Save It? Pension Lump Sum Distributions and Tax Reform. Washington DC: Employee Benefit Research Institute. (See especially pages 48, 55, 77-79.)

8. Izzet Sahin. 1986. Job Mobility and Private Pensions. Brookfield WI: International Foundation of Employee Benefit Plans.

9. Bureau of Labor Statistics. 1987. "Most occupational changes are voluntary." BLS News Release. Thursday, October 22, 1987. Table 5. Blau, Francine and Marianne A. Ferber. 1986. The Economics of Women, Men and Work. Englewood Cliffs NJ: Prentice-Hall (p.205).

Mr. ANTHONY. I would like to address this question, I guess maybe to Mr. Reuther and Mr. Bertnolli. It is about the simplified employment pension plans.

You seem to indicate that you would support them. You encouraged and said that maybe this was where small businesses may look.

My question would go back to Mr. Reuther. Would your association support added incentives or do you think that that would be a bad direction in which to go?

Mr. REUTHER. There have been some proposals to make SEPs available to all employers. We don't object to that, but would strongly oppose any tax credits to employers establishing SEPs.

First, we don't think the Federal Government has the money to start handing out additional tax credits. It would be very expensive.

Second, I think you have to look at the total context. With the large budget deficits there have been persistent calls for cutbacks in Social Security and the COLA. It is wrong to start cutting back on Social Security and on the other hand to be giving additional tax credits for things like SEPs.

Mr. ANTHONY. But at the beginning of your testimony, you acknowledge that 45 percent of the workforce is not covered and you want to cover it.

How do you juxtapose more people being covered and trying to use the methodology to encourage small businesses—we are talking employers with less than 100 employees—would that not be a good public policy goal to try to encourage those 45 noncovered workers to be covered even if it ended up costing us a little money. You are talking about priority. All we have to do is cancel one battleship.

Mr. REUTHER. The goal of expanded coverage is good and a first step towards that would be making SEPs available. It is the second step, the financial incentive that we would object to.

I think it is a mistake to think that you are going to have a private pension system with as much coverage as Social Security.

Mr. ANTHONY. I want the other witnesses to answer the question and then we have to leave for a vote.

Mr. BERTNOLLI. The electronics engineers with computer scientists pretty much included turnout to have a lot of entrepreneurs, and thus we are talking about a lot of people who generate new businesses, 100 people and under, as you indicated.

I think it is our experience, not in every case, but the thing that they find voluntarily works out best for them and their employees generally is a SEP. We feel—theoretically I can't tell you yes or no, but practically that seems to work best, so I suggest you encourage it.

Chairman PICKLE. Mr. Schulze.

Mr. SCHULZE. I have no questions, but would like to thank the panel for their presentation.

Chairman PICKLE. There has been a vote called. I think we will probably submit questions to you in writing and ask you to respond to us. And we will not come back in this room, but at 1 o'clock we will resume at B-318 when we consider the development policies and practices on pension asset plans, which I think is very important.

Now, I assume from your testimony that most of you would be in favor of the Federal Government taking some kind of action concerning portable pension plans, if we can work it out. Whether we do it with some kind of a plan that Mr. Reuther recommended or whatever it takes, that the Federal Government ought to find some way to give more pension portability for these mobile service jobs. That will not be easy, or we would have done it long since. Thank goodness we have Social Security. We must keep that strong and keep people's hands off of those Social Security funds.

Meanwhile, this committee will be further studying the question of portability. It is a serious question and I don't know that there is a perfect answer, but we will be looking for that approach, and I appreciate your testimony very much. Thank you very much.

[Whereupon, at 12:05 p.m., the hearing was adjourned, to proceed to other business at 1 p.m., this same day.]

[Submissions for the record follow:]

STATEMENT OF
THE PENSION COMMITTEE OF THE
AMERICAN ACADEMY OF ACTUARIES
AND ITS SUBCOMMITTEE ON PENSION
PLAN POLICY AND DESIGN ISSUES

On behalf of the Pension Committee of the American Academy of Actuaries and its Subcommittee on Pension Plan Policy and Design Issues, the following comments are offered to the Subcommittee on Oversight of the Committee on Ways and Means of the United States House of Representatives, on the subject pension plan portability.

STATEMENT OF INTEREST

The American Academy of Actuaries is a professional association of more than 8,500 actuaries which was formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition of the profession and more effective public service by the profession. The Academy includes members of the three founding organizations: the Casualty Actuarial Society the Conference of Actuaries in Public Practice and the Society of Actuaries. In addition, the Academy has within its membership more than 85% of all actuaries enrolled pursuant to the Employee Retirement Income Security Act of 1974, as amended. Enrolled actuaries are involved with the design and especially the funding of nearly all qualified defined benefit plans, and many defined contributions plans.

As the actuarial organization representing the overwhelming number of enrolled actuaries, the Academy is in a unique position to offer comments to the Subcommittee on Oversight of the Committee on Ways and Means on the efficacy of the numerous proposals that have been recently made to enhance pension plan portability. What are the administrative implications of these proposals? Will these proposals advance or hinder the development of a national retirement income policy? What will be the likely effect on the voluntary private pension system? Even if a proposal has great merit, is now a propitious time to act; or is it in the long-term interest of the system to allow employers time to digest the myriad legislative changes that have already been enacted, but not yet implemented?

The possible need for pension portability should be analyzed within the perspective of long-range pension concepts, not simply in response to immediate demands and notions of equity. The best beginning point is not with the question of "should we have portability:" rather, it is worthwhile to begin an analysis of pension plans and portability with a brief review of how ideas on effective pension planning have evolved over the last generation. To put this another way, the issue of pension portability is more than just experimenting with percentages and numbers. It requires a retirement income philosophy; and that may depend on whether one is taking a long- or short-term perspective.

DEFINITIONS: WHAT IS PORTABILITY?

Many commentators correctly noted in the July 12, 1988 hearing of the Subcommittee that is necessary to define terms carefully in discussing portability. There are two central issues:

(1) There is a benefit differential, called a "portability loss" (or gain), between the total pension benefits of a mobile employee who works for many employers over his or her lifetime and the total pension benefits of an employee who only works for a single employer.

(2) Is this benefit differential (more often a portability loss than a portability gain), "fair" in the context of tax equity and social policy?

There are a number of different contributing factors to portability losses by mobile employees. Each of these is an aspect of the question, and needs to be separately defined.

Portability of assets refers to the ability to obtain a distribution of pension benefits and to move the value of the accumulated benefits from one vehicle to another.

Preservation of assets refers to the fact that some employees that now receive a pre-retirement distribution of their retirement benefits use the distribution for other purposes than retirement savings.

Coverage and Comparability: In the voluntary private pension system, different employers provide different levels of retirement benefits to meet differing employer objectives. Some employers do not provide pension benefits at all. The relative

emphasis between salary, pension benefits, and other benefits also varies greatly from employer to employer, depending on their overall compensation and benefits philosophy.

The form in which benefits are provided also varies. Defined benefit plans provide pension benefits in the form of monthly income deferred until retirement, determined by a benefit formula. Other plans make a defined contribution to individual account balances. These plans only promise the size of the contribution, and do not provide a guaranteed level of retirement income. Many employers have both types of plans; one with defined benefits and one with defined contributions.

Portability of benefits refers to vesting. The employee who frequently changes employers may not become vested in any benefit.

Portability of service refers to the ability to count years of service under a plan of a prior employer in determining pension benefits from a new employer.

Portability of inflation protection: Inflation protection is best provided by final average defined benefit plans to long-service employees. A typical benefit formula will provide retirement income equal to a percentage of the employee's average compensation over the last five or ten years of service. Benefits for a long-service employee would be based on the five or ten-year average earnings at retirement, automatically providing protection for inflation that occurred during the employee's working lifetime. However, the benefits from an early-career employer of a mobile employee will generally be based on the five or ten-year average salary at the time of termination. Final average defined benefit plans generally do not index benefits for inflation that occurs after termination of employment from each employer. Thus, future inflation erodes the real value of deferred retirement income. This is the most significant factor in portability loss, and only occurs in final average defined benefit plans. Other types of pension plans (such as defined contribution plans) do not provide the inflation protection in the first place, even to long-service employees. The nature of these other types of plans is to base benefits or contributions on current year compensation, so benefits become based on career average income.

SUMMARY OF ISSUES

In the remainder of this Statement, the following issues are addressed:

- The need for a national retirement income policy as a critical first step in trying to create a balance between tax policy and social objectives.
- The need to allow time for previously legislated changes to be implemented and studied before further changes are made.
- Portability of inflation protection is discussed in detail, since it is the primary factor in portability loss.
- Asset portability and preservation are addressed, since many recent proposals have centered on these topics.
- Conclusions are summarized at the end of this Statement.

NATIONAL RETIREMENT INCOME POLICY

Qualified retirement plans have been an increasingly frequent subject of federal legislation and regulation over the last 15 years. The constant change in the rules governing the environment of qualified plans has added a tremendous burden to all sponsors who want to operate a qualified plan. The changing rules also operate as a disincentive to sponsors who want to establish new plans. Tax policy (as compared to social policy) now seems to play an ever-increasing role in the debates and the recent legislation in the retirement area. Examples of this include:

1. Changing 415 limits (Section 415 of the Internal Revenue Code puts a limit on the maximum benefit or contribution that can be provided by a qualified retirement plan).

2. The recent OBRA '87 bill added a new (and lower) threshold for the full funding limit for defined benefit plans. Estimates are that as many as 60% of all defined benefit plans may be at the new full funding limit. This means that plan sponsors cannot make contributions until plan assets fall back below the full funding limit. In effect, plan funding is delayed until some later date (thus generating some tax revenue over a short-term period).

3. Also added by the recent OBRA legislation are the new interest rate corridors for measuring the "current liability" under Section 412 of the Internal Revenue Code. This is another attempt to impose new and tighter restrictions on funding for defined benefit plans.

The American Academy of Actuaries' Pension Committee believes that the establishment of a national retirement income policy is the most important issue in the employee benefits area today. We believe it is a critical first step in trying to create a proper environment (and balance) between tax policy and social objectives. We believe this is a first step because stability needs to be the hallmark of any national retirement income policy. We need a more stable tax, economic and social environment that will allow plan sponsors to establish longer-range objectives for providing appropriate retirement income to their employees without the need for annual changes caused by short-term tax or revenue considerations. We must start now to create a more known environment so the government, private employers and even each individual can begin to formulate plans for dealing with this important issue. We see three key elements to a national retirement income policy:

1. The adequacy of the initial retirement income. The income should be enough to maintain the pre-retirement standard of living.

2. The age at which people are retiring. Data shows that people keep retiring at earlier ages despite changes in Social Security and despite changes in life expectancy. People now spend a greater percentage of their life, on average, in retirement than at any time in the past. This puts a huge financial burden on all of our retirement systems.

3. Continued maintenance of an adequate retirement income in the period after retirement. This is an area where social policy overlaps into economic policy, since inflation is such a critical issue.

Again, we cannot overemphasize the need for a more stable pension environment. For the better part of two decades, the voluntary private pension system has been subject to continuous rule changes. The sum total of these almost annual "reforms" has been unnecessary complexity, increased administrative expense, and the loss of focus on what the law and policy should do: (1) encourage employers to offer pension plans to their employees, and (2) protect the retirement income provided by those plans.

With the continuing flow of legislation and regulations, particularly since 1981, simply keeping up with the changes--good, bad, or indifferent-- is difficult enough. The administration of private pension plans has become so complex, and has changed so frequently, that the typical plan sponsor is finding it very difficult or impossible to cope at all. Congress should place a moratorium on its annual changes to the private pension system and allow some needed breathing space for the system to assimilate the backlog of changes already enacted (other than reversing some of the excesses of prior legislation, and technical corrections).

We are now aiming at a rapidly moving target. It is impossible to assay the effect of any further changes when sweeping prior legislation will not be implemented for another year. We cannot continue to "wing it." With the pension world in virtual chaos, any change, no matter how well-intentioned, could have unanticipated and deleterious consequences.

PORTABILITY OF INFLATION PROTECTION

In David M. Walker's statement on July 12, he estimated that indexing the vested benefits of separated participants to inflation could eliminate up to two-thirds of total portability losses. Because of the short time for a written statement, we have not had time to verify the calculations, but they seem reasonable. The heart of the portability issue, as measured in the dollars and cents effect on portability loss, is the inflation protection provided in final average defined benefit plans to long-service employees.

A Historical Perspective

In order to consider the issue of portability protection, it is vital to remember the historical development of these plans. The great majority of defined benefit pension plans were once based on career average pay. For example, for each year of credited service, an employee would receive credit for 1% of compensation recognized for that particular year. If the plan continued on this basis throughout an employee's career and retirement occurred after 30 years of service, then 30% of the employee's average pay throughout his or her entire caree.· would be payable as the pension.

It is obvious that this would be far from adequate. Even if there had been no inflation over that 30-year period, the amount of the pension would be adequate only if the pay level remained fairly constant. A typical employee would receive merit increases, so that in order to reflect an attained pay level fairly close to retirement, it would be necessary to "update" pension credits periodically to bring prior pension credits into line with the current pay level.

Supporters of the career average concept pointed to its inherent conservatism and the continued control by the employer to assume new updating liabilities only when and to the extent that they would be financially affordable. In contrast, those in favor of the final average pay approach maintained that the assurance of an adequate pension is paramount and that the employee should be able to rely absolutely on having his or her pension based on average pay over a limited period close to retirement.

In practice, for long-service employees there might be little difference between a final average pay plan and a career average plan which was periodically updated to make prior pension credits adequate in terms of current pay levels. Even the modest rates of inflation which prevailed through the mid-1960s, combined with merit increases, made it necessary for financially stable, conscientious employers to operate their career average plans as if they were final average pay plans by use of updatings every three to five years. As more and more companies came to appreciate the blurring of the distinction in practice, a major trend developed during the 1960s from the career average to the final average concept.

Final pay plans, then, became popular as employers sought to assure adequate retirement income to their employees, and to provide an incentive for longer service.

Paradoxically, as employers have committed to final average pay plans, many employees will receive, in effect, career average benefits as a result of frequent job switching. There is a new mobility about the land. For example, if an employee changes employers at ages 35, 45, and 55, pension accruals at retirement will be based on five or tens years final average pay calculated at 35 from the first employer for service prior to that age, on five or ten year final average pay calculated at age 45 from the second employer for the next decade of service, and so on. If the employee switches companies more frequently, he may never become vested, and receive nothing at all.

It should be noted that inflation-protection is a two-pronged issue, referencing not only mobile active workers, but also cost-of-living adjustments for retirees. Any legislative response to portability is without teeth if it does not address inflation protection. And any action on inflation protection is partial and flawed if it does not consider post-retirement as well as pre-retirement inflation. The issue of post-retirement inflation protection is becoming more important with continuing trends of earlier retirement ages along with increasing life expectancies.

Tax Equity

The July 12 statement by the Congressional Budget Office (CBO) concluded that "the current pension system poses serious issues of tax equity. In particular, people with equivalent lifetime incomes may get very different gains in retirement income from the tax advantages of qualified plans, depending on their work histories." The statement also noted that "the projections indicate that the tax advantages are three to six times larger for those with long plan tenure than for those with shorter tenure."

We disagree with these conclusions, even using the data presented by the CBO. For retired couples in 2019 (projections for workers ages 34 to 43 in 1988), the CBO derived the following results:

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	In 1988 Dollars	
	Pension Benefits	Tax Advantages
Less Than Twenty Years in One Plan	$5,546	$1,830
Twenty or More Years in One Plan	21,122	8,066

The tax advantages are 33% of pension benefits for those with less than twenty years in one plan, and the corresponding ratio for those with more than twenty years in one plan is 38%. These ratios are relatively close, indicating that tax-advantaged dollars are a fairly level percentage of pension benefits. This seems to be a confirmation of the fairness of the distribution of tax advantages, particularly when one considers the fact that the CBO grouping of retirees without twenty years in one plan includes employees who were never in any plan at all! A comparison of short-service employees, in companies that have plans, to long-service employees in companies with plans would yield quite different results, presumably even closer. In short, the results presented by the CBO include the effects of incomplete coverage, of employers without any plans at all, and do not directly address the relative tax advantage benefit percentages of only those long- and short-services employee who have pension plans.

It all depends on what is meant by fairness or by equity--how you define the concept. As demonstrated by David M. Walker, the primary factor in portability loss is inflation. Inflation is the cause, portability loss is the resulting effect.

Alternatives Addressing Portability of Inflation Protection

All the suggested alternatives addressing portability of inflation protection, save one, would represent a tremendous and fundamental change in the structure of the voluntary employer-based pension system. One alternative would be to mandate inflation indexing of benefits for those who terminate employment. The indexing might be provided either by the prior employer or by the new employer. There is little real difference between the two variations. The voluntary nature of the system would be lost if such a sizable benefit increase was legislated. Employer costs could increase by 30%. Far more likely, future retirement income levels might be decreased (by plan amendment) by the same 30% in order to keep costs constant. Basically, the benefit security of long-service employees would be lessened to provide more benefits to short-service employees on a mandatory basis. A cost increase or benefit redistribution of this magnitude would certainly provide a disincentive to form or continue defined benefit plans (and this approach does nothing to help workers who depend completely on defined contribution plans for their retirement income).

Indexing would constitute a policy of encouraging mobility. Defined benefit amounts would not be lost to inflation upon changing jobs, so the incentive to remain with one employer would be gone. Is this a wise policy? The preponderance of employers seem to seek to enhance retention of employees. Why do most employers think retention of employees will help their companies? Are most employers wrong? Would they be better off with employees with less grounding in their own operations, but more knowledge of practices elsewhere? The issue seems far from clear whether the federal government should take a firm stance encouraging mobility.

Further, it would be difficult to mandate inflation protection prior to retirement, but not after. Inevitably, indexing for mobile active employees would be expanded to include indexing for retirees. The philosophical justifications of both are the same. The one-two punch of pre and post-retirement inflation protection could easily double plan costs. Going even further, other countries that have mandated indexing have inevitably found it necessary to follow through with a knockout blow to the voluntary nature of the private pension system by also mandating coverage. For at double the costs, who will continue their defined benefit plans voluntarily?

Summarizing, in other countries, inflation indexation of accrued benefits of "early leavers" has demonstrated a domino theory of pensions, with accompanying post-retirement indexation and eventual mandated coverage, sounding a death knell for the voluntary pension system. Mandatory indexing of benefits is a very serious step.

A second alternative often mentioned is an interesting counterpoint to mandated indexation, namely the mandatory use of defined contributions plans, which don't have inflation protection for long-service employees. Make all employees "even," either by assuring that everyone receives inflation protection or that no one receives it. If a

minimum defined contribution element was mandated, either costs would go up to provide this new benefit, or other benefits would decline to keep costs level. Again, there is a levelling effect, and an erosion of the voluntary nature of our pension system.

There is another alternative, that of leaving the future of defined benefit plans to the give-and-take of the marketplace. The American Academy of Actuaries supports the voluntary nature of the private pension system. Just as the system was self-correcting in the 1950's and 1960's, supplanting career-average defined benefit plans with final-average defined benefit plans, so it will be self-correcting in the future.

Already, in the 1980's there has been a large and voluntary movement towards defined contribution plans, which often serve to retain young and mobile employees just a little bit longer in situations where defined benefit plans have no appeal to these employees at all. A large share of employers offer both defined benefit and defined contribution plans.

With the continuing greying of America, the voluntary environment is constantly changing. Not only will the mix of defined benefit and defined contribution plans change in response to market forces, but the mix between salary, pension benefits, and other benefits will change as well. As the baby boom generation makes its demographic mark on the country, the benefit marketplace will inevitably respond. Quite possibly, as the baby boomers age, defined benefit plans will become of such paramount importance, that they will enter a new ascendancy. Or perhaps, as the following baby bust generation enjoys more employment opportunities than ever before with a heightened mobility, defined benefit plans could meet a natural death. The voluntary private pension system will adjust naturally, if we just let it.

Avoiding mandatory quick-fixes and preserving the voluntary private pension system does not imply that we can do nothing about the portability of inflation protection. The answer is to address the root of the problem: inflation. It is well beyond the scope of our expertise to suggest how to do this. But it is not beyond our expertise to be confident that we should treat the disease, inflation, and not it's symptom, portability loss. The real problem of inflation will not go away if we suppress its symptoms, but it will inevitably reappear in another form with new symptoms.

We would also point out that there are some current constraints in suppressing inflation projection for plan participants. Current funding regulations do not allow an enrolled actuary to project (and consequently to begin funding) for projected benefits above the current Section 415 Limit. As the 415 Limit has been lowered due to the law changes, it is impacting on the funding of projected benefits for rank and file employees as well as higher-paid employees. Allowing for projection of the 415 Limit would then allow employers to fund not only for projected benefits under the current plan formula, but also for post-retirement increases if they are allowed by the plan.

ASSET PORTABILITY AND ASSET PRESERVATION

A. Asset portability is the ability to obtain a distribution of pension benefits and to move the value of the accumulated benefits from one vehicle to another. The movement of the benefits from one vehicle to another does not affect the value of the benefits. However, requiring plans to offer a cash-out option would allow mobile workers to combine several small pensions into one. As an alternative, plans might not be required to allow lump sums; but if they voluntarily offer lump sums, they might be required to perform trustee to trustee transfers.

These proposals seem innocent enough at first glance, and may be worthy ones. We have four comments:

1) There is a potential problem if plans are mandated to provide lump sums. If a plan is currently underfunded, a requirement to pay 100% value in a lump sum on behalf of terminated employees would lessen the funded ratio for those who remain. The benefit security of the remaining participants would suffer harm, and the potential liability of the Pension Benefit Guaranty Corporation might be increased.

2) Earlier in this Statement we noted our belief that further pension legislation should be subject to advance dialogue and study, that time should pass before any further changes are made, and that the first step is the formation of a national retirement income policy.

3) It has also been proposed that a federal clearing house be set up to accept these distributions. It is difficult to imagine why such a clearing house would be needed. A private equivalent, the IRA, already exists that can do everything that would be asked of the clearing house.

4) Some plans promise a defined benefit amount, some promise an annual contribution. Moving benefits between plans may change the form of the benefit promise. This is of particular concern if defined benefit promises are translated into defined contribution promises, and then suffer some loss due to poor investment performances just before retirement.

B. Asset preservation refers to the use of pre-retirement distributions for other purposes than retirement savings. Also, distributions of employee contributions are not allowed to be transferred to an IRA. Proposals have been made to: (a) allow employee-contribution-to-IRA transfers, (b) to mandate use of pre-retirement distributions for retirement purposes, and (c) to restrict lump sums at the time of retirement as well.

The proposed restrictions on pre-retirement distributions are understandable. It is not unreasonable to expect that tax-favored investments be used for the purpose for which they are protected: to provide retirement income. But no changes are needed yet, since the new 10% excise tax on many of these distributions may well reduce their incidence.

However, limitations on lump sums after retirement are not as clear an issue. First, a reason for the change should be demonstrated. Why make such a change? Further study is needed to demonstrate a need for a post-retirement restriction on lump sums.

CONCLUSION

The American Academy of Actuaries applauds the Committee on conducting these hearings. Legislation in pensions should only be passed after due consideration, study, and exchanges with the private sector; not only on the broad policy issues but also on the details of the legislation. As a first step we call for the formation of a national retirement income policy. Until such time, Congress should place a moratorium on further changes until the system absorbs the backlog of changes already enacted (other than reversing some of the excesses of prior legislation and technical corrections).

The primary source of portability loss is the lack of portability of inflation protection for early leavers. This is a difficult problem to address. The mandated inflation indexing of pre-retirement accrued benefits has been followed in other countries by eventual mandated inflation indexing of post-retirement benefits, and then by mandated overage. As supporters of the voluntary private pension system, we oppose this approach. An alternative to indexing, of a mandated minimum defined contribution plan, also violates the voluntary nature of the system.

The need for portability of inflation protection is a symptom. The disease is inflation. Congress should treat the disease, or else new symptoms will be sure to appear.

Questions of asset portability and preservation are not central to the issue of portability loss. Any introduction of asset portability should be designed in such a way as not to harm the funded status of underfunded plans. The need for a federal clearing house is not clear. On the other hand, the desire for preservation of pre-retirement asset distributions is understandable and not unreasonable. However, it is too soon to tell whether the new 10% excise tax has already achieved this preservation.

The American Academy of Actuaries is uniquely qualified to quantify the factual implications of any specific policy proposals. We would be pleased to provide further input as this dialogue progresses.

THE FOLLOWING EXCERPT WAS SUBMITTED BY
MERTON C. BERNSTEIN, WASHINGTON UNIVERSITY IN ST. LOUIS, MISSOURI

SOCIAL SECURITY: THE SYSTEM THAT WORKS, Merton C. Bernstein and Joan Brodshaug Bernstein
BASIC BOOKS, INC., New York (1988)

What Role for Private Pensions?

Private pension plans might conceivably play various roles: continuing to supplement Social Security, primarily for the better paid; providing supplementation for more people through better coverage and more generous benefits; supplanting Social Security; supplying smaller supplements, with Social Security assuming a larger responsibility. Alternatively, principal emphasis could be placed on individual plans, like IRAs, putting people on their own (see chapter 10).

Supplementary private pensions are, as now structured, undependable. They cover only about one-half of the private work force, at best. Claims of improving coverage are scarce. Claims of improved yield in the future should be viewed skeptically given the accelerating rate of change in the economy and the demonstrated instability of employment. Even with the five-year vesting required by the 1986 Tax Reform Act, the odds do not favor splicing together sufficient pension credits to add up to a substantial benefit for most working people. And even the fortunate who receive benefits will usually see their value eroded by inflation.

Private Pension Reform—What Might Be Done[1]

The question arises whether these shortcomings can be overcome by some redesign. Improving plan coverage, vesting, protection against the ravages of inflation, and effective representation of retiree interests are features that merit exploration even if these improvements cannot guarantee perfection.

Improving Plan Coverage: MUPS—Making Plans Mandatory. The President's Commission on Pension Policy, launched in the Carter administration, chose pension coverage as the most salient problem pension policy faced. The commission assumed that Social Security benefits were too low to sustain preretirement living standards. It further assumed that expanding Social Security's role was undesirable, although it did not explain why. It concluded that adequate retirement income depended on supplementing Social Security with an additional layer of retirement income for all employees. Its 1981 report[2] recommended a Mandatory Universal Pension System, frequently known by the acronym MUPS.

The proposed system would require all but the smallest employers to make a minimum pension contribution for every year of service beyond the first. With full vesting after one year of service, a large part of lifetime employment would

produce retirement savings. Spread over almost all employees and their full working lives, each unit would be low-cost—a key element to make the proposal attractive. Only small amounts would be contributed, estimated to start at 3 percent of pay. Before the resulting supplement could create a significant benefit, fifteen or twenty years of plan life, in many cases longer, would be required. Social Security met that start-up problem by granting benefits exceeding the actuarial value of the contributions made for individuals who retire in the early years of the program or of program improvements. Private defined-benefit plans typically give past-service credit for periods worked prior to plan inception, thereby providing more adequate benefits for those who retire early in the life of such a plan. But the past-service liability thereby incurred can be substantial. Plans that would come into being only in response to MUPS would be in the employment sectors now hardest to cover and least able to fund pensions. MUPS proponents did not propose providing past-service credit.

Most economists regard pension contributions as part of the total compensation package, a total which, over time, is fairly inelastic. An expenditure for one benefit comes from funds that would otherwise go into cash pay or another fringe. MUPS's greatest impact would be upon companies without a plan—typically small, low-pay enterprises; many such companies would respond by reducing employee pay or not improving it as they otherwise would. That result would not be cushioned by the earned-income credit and benefits weighted in favor of the low paid, devices used in tandem with Social Security to offset the burdens of the payroll tax. Some employers, on the other hand, do not accept the proposition that added fringes come out of other pay. Rather, they regard any new benefit as an addition to employment costs, which they resist. In any event, the cost of MUPS would get passed back to the employee, forward to the consumer, or both.

Despite the fact that pension credits would vest after only one year and ERISA's requirement that an employer not discriminate against an employee because of his or her eligibility for an entitlement, such antidiscrimination provisions are difficult to enforce. Frequent employee separation of low-skilled workers during the first year of employment would subvert both MUPS and ERISA. The enforced savings of both MUPS and Social Security would impose a higher rate of savings on the low paid. This double burden might subvert the integrity of Social Security if it led to reduced contributions to that program.

Whatever its merits, MUPS has produced little enthusiasm. The fact that a Carter-appointed commission reported the plan in the first days of the Reagan administration undoubtedly did not help. In any event, MUPS has no powerful patron pushing for its passage, despite the initial ardor of a few respected private pension specialists. So improved coverage will have to come from someplace else. For the moment, no one knows where that will be.

CHOICES

Defrosting Vested Benefits. In practice, five-year vesting will produce little benefit improvement. For those who qualify, even ten-year vesting promises only modest benefits, all the more so because vested benefit amounts remain frozen from the time of vesting. No one has yet suggested crediting exiting employees with plan improvements made between the time of separation and retirement. However, that would often improve benefits and achieve treatment equal to that for employees not separated. Equal pay for equal work has come to be regarded as fair. By freezing vested benefits, exiting employees receive less compensation for the credited years than employees who stay in the plan and participate in plan improvements based directly or indirectly on those same years of work.

Vesting that incorporates plan improvements would increase plan costs, which is the major reason that no one has proposed it.

Since five-year vesting promises often paltry benefits, widespread cashing out, which remains permissible,* may continue to be the rule. In addition, vested benefits which the employer or employee does not cash out stay "frozen" within the plan in which they are earned.

Pension Clearinghouse. What would be achieved if the present value of the vested benefit were transferred to the exiting employee's credit in a central fund or to a new plan that he or she joined; that is, if vested benefits were to achieve "portability?" Originally proposed in 1964,[1] a pension credit clearinghouse could:

- Combine bits and pieces of vested credits earned with different employers;
- Finesse the problems encountered in transferring vested credits into employees' next plans;
- Provide separated vested employees with a chance to have their credits participate in economic growth;
- Enable separated employees to invest their vested credits in an expertly-managed and diversified fund;
- Relieve plans of the bother and expense of keeping track of vested credits for former employees.

Many vested credits simply are so small that they do not warrant the cost and bother of investing, which is why ERISA permits employers to cash out benefits with a present value below $3,500. Further, many employees lack adequate information about investment choices and their value. A clearinghouse that meets standards prescribed by statute and regulation could provide a means of reinvesting the credits in a retirement fund. With standardized procedures

* The 1986 Tax Reform Act requires separating employees who do not "roll over" amounts distributed into another qualified plan to pay a 10 percent additional tax.

such a transfer could be as easy and inexpensive as shifting a modest bank account when moving to a new city. To facilitate reinvestment of vested credits and to discourage cashing out, most employees need the financial equivalent of McDonald's, Burger Chef, and Wendy's—not sophisticated fare, but a known and readily accessible option.

The availability of such a device might warrant mandatory preservation, "locking in" of vested credits, even small ones. That becomes justifiable if separating employees have a reasonable expectation of obtaining credits from more than one job. If vesting were required after one year of service, more employees would obtain vested credits from more jobs than under five-year vesting. As a clearinghouse program matures, the plan for the last employer prior to retirement would bear less of the burden. (Currently it supplies most or all of the benefits to be obtained from private plans.) That, in turn, would enable plans to reduce the benefit attributable to each year of service, thereby lowering per capita per annum costs and facilitating the installation of plans and the introduction of early full vesting.

A clearinghouse avoids a major problem presented by vested credits: translating such credits into credits in another employer's defined-benefit plan. Instead, a clearinghouse lodges vested credits in a money-purchase plan operated for thousands of others similarly situated.

At the same time, a clearinghouse relieves a plan from which an employee exits from the cost and bother of carrying the value of vested credits or administering future benefits, which differ from those of employees whose employment continues. Not unimportant, even if former employees keep track of their entitlements from former jobs (which ERISA instructed the Social Security Administration to do for them), the plans and the former employees may not keep track of each other. If a plan terminates, combines, or is transformed into another financial arrangement, the former employee may not be able to locate the responsible party, if there is one, when the time comes to make a retirement benefit claim.

A most important reason for establishing clearinghouse arrangements would be to give former employees with vested credits a fighting chance to have those credits participate in economic growth. Investing the value of the credit in the clearinghouse might enable their credits to grow with the economy. However, when a plan pays out the present value of a vested credit, it discounts the assumed earnings of that credit during the years until a benefit will be drawn. In order for the value of the vested credit invested by the employee—in a clearinghouse or otherwise—to increase, the interim actual earnings must exceed the earnings rates assumed in setting the present value. Nothing about a clearinghouse overcomes those discounts unless the permitted discount is held low enough by regulation to make improvements likely to exceed the rates assumed.

PBGC now sets the interest rate assumption for cashing out benefits into their present value. The resulting rates have not provided much protection to employee interests.

So, the principal utility of a clearinghouse would be that it salvages credits that otherwise would be cashed out. While that problem could be met by prohibiting cash outs, the bits and pieces of vested benefits thereby preserved require a device for their accumulation; otherwise administrative costs can be disproportionally high.

A clearinghouse, or a series of clearinghouses with transfers among them, could be either public or private entities. The latter would minimize the problem presented by private investment decisions being made by public officials. A private enterprise might well be more acceptable than "another federal bureaucracy."

In addition, a private clearinghouse arrangement also might offer basic plan coverage for small employers. The availability of such a carrier, with prescribed minimum benefits keyed to the needs of small companies, could facilitate the installation of plans in an area where the costs and burdens of plan installation and administration now discourage plans.

However, such a scenario requires starting somewhere. As the preceding discussion of MUPS indicates, instituting a new program while maintaining existing programs (Social Security and supplementary programs) commandeers additional resources for retirement income purposes when other demands often are more urgent, especially for low- and middle-income earners. As with MUPS, many years must pass before substantial improvement in retirement income would result.

STATEMENT OF THE NATIONAL EDUCATION ASSOCIATION

Mr. Chairman and Members of the Subcommittee:

The National Education Association represents 1.9 million instructional and education support employees in elementary, secondary, vocational, and postsecondary schools. NEA has long been concerned about the serious problems related to a lack of pension portability, both as it affects individual education employees and as it hampers our nation's ability to attract and retain qualified classroom teachers and other school staff persons.

From the point of view of an individual, there are numerous advantages to portability. It preserves for pension income certain amounts that would otherwise be paid as lump sum distributions. It protects vested pensions against inflation. And it enables and encourages earlier vesting.

Improvements in pension portability, as with other material rewards of education professions, help encourage individuals to enter and stay in education professions, and therefore serve a public policy end, as well as being advantageous to the individual. In addition, there is a key educational need served by improving the portability of pensions — encouraging and allowing greater mobility for teachers to address teacher shortages.

The teaching profession has been mobile over the years as new challenges and employment opportunities have expanded the education field. This mobility has given teachers an opportunity to share their particular knowledge and experiences with students of many socioeconomic, ethnic, and cultural backgrounds and has allowed them to take advantage of higher wage offers in various segments of the country. Equally important is the fact that this mobility has helped many sections of the nation combat serious teacher shortages.

NEA estimates that one-half of today's current teaching staff will leave the teaching profession within the next five to 10 years, and the number of people entering colleges of education is far short of the projected need. According to the Carnegie Forum on Education and the Economy, public elementary and secondary schools will need at least 1.3 million new teachers by 1993. Already, there are serious spot shortages in certain geographic and subject matter areas, and the full extent of the teacher shortage is masked by the practice of misassigning teachers, that is, placing teachers in classes they are not certified to teach, and the practice of simply dropping courses. Both urban and rural school districts are hard hit. In Los Angeles, for example, there are not even enough substitutes, much less qualified teachers, to cover all the classes. New York City and Georgia are among areas that have attempted to fill teacher shortages by recruiting individuals from Spain, Germany, and other foreign countries.

The loss of retirement benefits is a major impediment to teacher mobility outside the boundaries of a given state, and for teachers moving to or from Overseas Dependents Schools. Retirement benefits a teacher has earned by service in one state will, in most instances, be lost if he or she accepts a teaching position in another state. This loss of retirement benefits occurs because 1) the state the teacher leaves may not allow for early vesting; or 2) the state the teacher enters may not grant retirement credit for years of teacher service performed outside its boundaries. Even if a teacher receives a retirement benefit from prior employment, the value of that benefit is diminished by inflation compared to a benefit resulting from continuous employment in one school system. The U.S. Department of Labor estimates that — in defined benefit plans — indexing benefits could eliminate 66 percent of pension benefit losses, and that requiring all employers to credit all service would effectively eliminate all portability losses.

A recent NEA survey of our members helps show the extent of this problem. Of those responding, more than 25 percent had taught school outside the state in which they are currently teaching. Of those who have done so, some 74 percent have lost retirement credit for that out-of-state service. By comparison, a U.S. Department of Labor study reported that 59 percent of workers covered by pensions experienced some portability loss, with average loss estimated at 25 percent of the single career benefit. In terms of years of service lost, our study shows that almost 65 percent of teachers surveyed have lost up to five years of service credit, almost 27 percent lost from five to nine years of credit, and almost 9 percent lost more than 10 years of service. Clearly this is a substantial burden borne by teachers and a significant disincentive for members of the profession to move to another state.

When teachers are forced into immobility by the probability of losing retirement benefits, students around the country are deprived of the opportunity to be taught by persons of varied backgrounds and expertise. And states and school districts lose a potential pool of valuable applicants to fill teaching positions.

Moreover, in that enrollment patterns and funding — from local, state, and federal sources — are not always consistent from year to year, interuptions in service are often beyond the control of education employees.

The Pension Portability Act, H.R. 1961, would begin to address one aspect of this very serious problem. It would allow teachers, should they leave a retirement system, to retain their contributions in tax-free pension investments. This could result in a substantial improvement in benefits to those individuals who would otherwise be forced to pay taxes on any interest their funds had generated or would be forced to invest those funds in taxable investments. The number of those people is expected to grow substantially as a result of changes created by the Tax Reform Act of 1986 which limited individual retirement accounts for individuals in certain income categories.

Even with the passage of this legislation, several significant barriers to pension portability for teachers remain. The U.S. Department of Labor estimates that mandatory rollovers of lump sum distributions would reduce losses in retirement benefits by only around 1 percent. A far more serious obstacle to teacher mobility is the loss of service credit when an individual switches from one system to another.

There are vast differences among the various state retirement systems. Some cover only teachers, some cover teachers and other education employees; in some states, teachers participate in a public employee system. Some states pension systems are adequately financed; some have large accrued unfunded liabilities. The level of benefits for education employees range from accural rates of 2.5 percent to 1.5 percent. Some teachers are covered by Social Security and/or Medicare while others are not. Admittedly, developing a means by which individuals can be treated equitably as participants in the retirement systems of two or more states can be difficult. But NEA has worked closely with the National Governors' Association to develop ways to establish reciprocity agreements related to service credit among the states and to establish procedures for individuals to "buy back" years of service from another state.

Other obstacles to fully addresing the lack of pension portability include the length of time it takes to become vested in certain systems; the loss of the employer contributions created when an individual withdraws contributions prior to vesting for retirement; the lack of minimum reporting, disclosure, and fiduciary standards relating to public penions; the lack of uniformity among systems ranging from terminology to benefits; and the problems created by the Tax Reform Act of 1986's elimination of the three-year basis recovery rule.

It is our hope that Congress will address each of these issues in order to provide teachers with the kind of pension security, stability, and mobility they need and deserve.

We appreciate the opportunity to comment on the proposed legislation, H.R. 1961, and we look forward to working with you to secure legislation in this vital area.

STATEMENT OF ROBERT W. LINN
DIRECTOR OF THE OFFICE OF MUNICIPAL LABOR RELATIONS
THE CITY OF NEW YORK
TO
THE SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS AND MEANS
CONCERNING ROLLOVER OF ASSETS
OF
AN ELIGIBLE DEFERRED COMPENSATION PLAN
OF STATE OR LOCAL GOVERNMENTS

JULY 25, 1988

I am Robert W. Linn, the director of the New York City Office of Municipal Labor Relations. I am submitting this statement on behalf of the City of New York to address one aspect of the issue of portability of retirement benefits which we believe should be addressed in any legislation to improve portability.

The City of New York urges the Subcommittee to include in any recommendations on portability a provision which would allow participants in an eligible deferred compensation plan under section 457 of the Internal Revenue Code (a section 457 plan) to rollover their plan balances to an individual retirement account (IRA), qualified plan, or other portability vehicle, as in H.R. 1992 sponsored by Congressman Rangel.

Section 457 encourages employees of state and local governments to save for their retirement. However, it is unlikely that any portion of those savings will remain for retirement planning without the availability of an IRA or other portability vehicle if the employee leaves governmental service prior to retirement.

We therefore recommend that when an employee separates from service he be allowed to elect to have the entire balance of his 457 plan account rolled over on substantially the same terms as other forms of retirement benefits. Although the Internal Revenue Code currently permits a rollover of distributions from one 457 plan to another 457 plan, many employees leave government service to become employed in the private sector. None of those employees has the option of rolling their 457 benefits over into another type of plan. In addition, many 457 plans require former employees to take their distributions on separation from service. They are not permitted to defer the distribution until retirement.

Allowing such a rollover has benefits for both the employee and the state or local government. The employee would be able to retain close control over the fund even after he has is no longer working for the government, and may not even be in the same locality. He also would be better able to integrate the assets of the 457 plan into his retirement strategy. The government would be relieved of the burden of administering the assets and keeping track of the former employee so as to be able to inform him of changes in the plan and send distributions to him.

Eligible deferred compensation plans are, at least in part, another form of retirement plan. The changes made in the Tax Reform Act of 1986 brought the 457 plans closer to qualified plans. Legislation which allows portability of the assets of other forms of retirement benefits should include the assets of 457 plans.

Under current law, an employee of a state or local government can agree to defer compensation, up to certain limits, under an eligible Section 457 plan. Although the employee does not have any right to the deferred compensation, or the earnings on the compensation (because such amounts remain assets of the government), the governmental unit generally maintains a funded account for the employee and lets the employee direct the investment of the funds. The amounts in the funds equals the amount of compensation the employee has agreed to defer plus the earnings on that deferral. The employee is not taxed on the deferred compensation, or the earnings, until it is made available to him or her. No employer contributions are made to an eligible Section 457 plan.

The funds may not be distributed earlier than when the employee separates from service, is faced with an unforeseeable emergency, or reaches age 70 1/2. The distribution must meet the minimum distribution requirements of section 401(a)(9) of the Internal Revenue Code and if periodic payments are made, they must be in substantially nonincreasing amounts.

The contributions and earnings in a 457 plan are employee contributions which have not been taxed. As a result, the objections usually raised to rollovers of after-tax employee contributions do not apply. There would be no need to keep track of the amounts rolled over separately since the entire amount of these benefits would be taxable on distribution.

Qualified plans and IRAs have, if anything, stricter standards for distributions and protection of spouses and other beneficiaries and do not allow distribution for unforeseeable emergencies. As a result, the rollover of amounts from a 457 plan to some other portability vehicle should be at the election of the participant. This would allow him to choose to subject these benefits to the additional requirements and loss of flexibility.

INVESTMENT OF PENSION PLAN ASSETS

TUESDAY, JULY 12, 1988

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to call, at 1:08 p.m., in room B-318, Rayburn House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press releases announcing the hearing follow:]

FOR IMMEDIATE RELEASE
TUESDAY, JULY 5, 1988

PRESS RELEASE #22
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A HEARING TO REVIEW THE INVESTMENT OF PENSION PLAN ASSETS

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing on the investment of pension plan assets. The hearing is scheduled for Tuesday, July 12, 1988, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 1:00 p.m.

The Subcommittee's hearing will examine the provisions of the Employee Retirement Income Security Act of 1974 governing the investment of pension plan assets, and the enforcement efforts of the Department of Labor and the Internal Revenue Service. In addition, the Subcommittee will review the impact of the recent fluctuations of the stock markets on the financial stability and investment practices of pension plans.

Witnesses expected to appear at the hearing include the Department of Labor, the Internal Revenue Service, the U.S. General Accounting Office, and the Employee Benefit Research Institute.

In announcing these hearings, Chairman Pickle made the following statement: "In recent years, the assets held by private and public pension plans has grown dramatically. The total assets of these plans now approaches $2 trillion dollars. These assets are the bedrock on which rests the retirement security of millions of workers. Therefore, it is essential that these funds are invested wisely. We must be certain that these pension plan funds are not being lost as a result of financial mismanagement, fiduciary abuses, or excessive speculation. The Congress and the public have a right to know where and how pension plan funds are being invested, and whether their investment practices are within the law."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons wishing to submit written comments for the printed record of the hearing should submit six (6) copies by the close of business, Friday, July 29, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

*** CHANGE IN LOCATION ***

FOR IMMEDIATE RELEASE
THURSDAY, JULY 7, 1988

PRESS RELEASE #22-REVISED
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A CHANGE IN LOCATION OF THE HEARING TO REVIEW
THE INVESTMENT OF PENSION PLAN ASSETS

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, today announced a change in the location for the hearing on Tuesday, July 12, 1988 on the investment of pension plan assets. The hearing will be held in room B-318 Rayburn House Office Building, rather than room 1100 Longworth House Office Building as originally announced. As previously announced, the hearing will begin at 1:00 p.m.

All other details for this hearing will remain the same. (See Subcommittee press release #22, dated July 5, 1988.

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Chairman PICKLE. We would ask the subcommittee to please come to order and ask our guests to please take a seat. The subcommittee is here this afternoon to begin to find out, if we can, where pension funds are being invested, what rules govern those investments, and how the government enforces them.

In total, our private pension funds in this country have assets in excess of $1.6 trillion, and the combined assets of all pension plans, public and private, almost surpasses our national debt. This is a lot of money. It has been described as the largest pot of capital in the world. It is that, and more. These assets form the foundation for the retirement security of over 42 million workers and their families. Every worker, every community, every business in America is affected by this national nest egg. Indeed, by virtue of the size of their stock holdings, our pension assets affect the economies of the entire world.

All this leads me to observe that we have put a lot of eggs in our pension basket. And, as the saying goes, we should be watching that basket very, very carefully. What are the rules governing the investment of these funds? Do the provisions of the Internal Revenue Code and ERISA adequately safeguard pension assets? What efforts do the Department of Labor and the Internal Revenue Service make to enforce the statutes and regulations? It is our intention to examine these questions today.

Our concern is that not only do the investment practices of our pension funds affect every aspect of our Nation's finances but also, in reverse, every aspect of our national economy has an effect on the financial security of pension plans. Certainly the precipitous decline in the stock market last October would make any reasonable person sit up and take notice. I am looking forward to hearing how the "crash" affected our pension plans.

On another point, when I think about the sheer size of the $1.6 trillion retirement-savings pool, I am reminded of Willie Sutton's famous line. When asked why he robbed banks, his response was, "Because, that is where the money is." I can't help but think that more than one person with a little larceny in his heart has set his sights on the assets of the private pension system. In the past, I know that there were extensive abuses in the case of the Teamsters' Central States pension fund. In light of the administration's recent actions regarding the Teamsters Union itself, I look forward to hearing about the current status of the Central States funds. But, even further, the subcommittee is interested in knowing what steps are being taken to prevent others from engaging in fraudulent pension practices.

Now, in saying all this, I do not mean to imply that I think that any specific plan fiduciary is violating the law. Rather, I want to know how the system is working and how we can prevent any fraudulent activity. I don't think the average person knows the power of these fiduciaries, or that they are handling so much of the workers' money.

This is a lot of ground to cover. We have some excellent witnesses prepared to testify today, so without any more delay, let us begin this review. We will proceed immediately.

I will ask Mr. Schulze if he has an opening statement this afternoon.

Mr. SCHULZE. Thank you, Mr. Chairman, I join you in opening this hearing today. The Wall Street decline of October of 1987, reminded everyone that there are no guarantees in the stock market. There is a mixture of risk and opportunity in investments.

The investment approach an investor uses depends upon who he represents. An individual who is vesting for his own account may decide to pursue speculative investments in the hope of achieving large gains, but he is also risking large losses.

However, institutional investors with a duty must invest their assets in a prudent manner. Pension fund managers are expected to follow this prudent investment standard. This involves balancing the investment gain against the risk.

While there is no magic formula to minimize losses, the pension law does impose fiduciary rules to help pension managers meet those objectives. The traditional standard is known as the prudent man rule. In addition, the rule requires investment diversion in order to avoid large losses. There are prohibited transaction rules to cure self-dealing and inside, sweetheart deals.

Today, the subcommittee will review the structure of these investment rules. We are interested to learn if the current rules are adequate or whether there are areas where they can be improved.

Mr. Chairman, I would join you in welcoming this afternoon's witnesses and look forward to their testimony.

Chairman PICKLE. Thank you, Mr. Schulze. Do either of the members have statements to make at this point? Then, the Chair calls our first panel—I will give it to you in just a minute—it is composed of Mr. William Posner and Mr. Alan Lebowitz. Will those two gentlemen please take their seats?

Mr. William Posner is the Assistant Director of the Employee Plans Technical and Actuarial Division, the Internal Revenue Service. And, representing the U.S. Department of Labor is Mr. Alan Lebowitz, who is the Deputy Assistant Secretary for Program Operations of the Pension and Welfare Benefits Administration. We will ask Mr. Posner to proceed first. Mr. Posner.

STATEMENT OF WILLIAM POSNER, ASSISTANT DIRECTOR, EMPLOYEE PLANS TECHNICAL AND ACTUARIAL DIVISION, INTERNAL REVENUE SERVICE, U.S. DEPARTMENT OF THE TREASURY

Mr. POSNER. Yes, thank you very much.

I very much appreciate the opportunity to appear before this subcommittee. With your permission, I would like to summarize and condense the parts of my prepared statement, but I ask that my full statement be inserted into the record.

Chairman PICKLE. Without objection, it will be so ordered.

Mr. POSNER. Thank you.

I am here today to testify on the exclusive benefit rule and the prohibited transaction rules of the Internal Revenue Code. These requirements are at the heart of the Service's efforts to assure that investments by qualified retirement plans are consistent with the objectives of ERISA.

Also, I would like to discuss our expanding employee plans examination program and the sanctions available to the Service. Finally,

I would like to provide an update on the status of the Central States Teamsters fund.

I will begin by reviewing the role of the Service with respect to qualified retirement plans. When a pension, profit sharing or stock bonus plan satisfies the requirements of section 401(a) of the code, it is referred to as a "qualified plan."

Although an employer is not required to establish and maintain a qualified plan, the code provides an employer with substantial tax incentives to do so.

Favorable tax treatment is expressly conditioned upon the plan meeting, both in form and in operation, the qualification standards of the code. These qualification standards require, among other things, that the plan does not discriminate in favor of highly compensated employees, that contributions and benefits are limited in amount, and that minimum participation and vesting standards are satisfied. They also require that the plan be for the exclusive benefit of employees and their beneficiaries.

Also, a qualified plan is prohibited from making investments, or otherwise dealing, with certain people or entities; that is, a qualified plan may not engage in a prohibited transaction.

I will more extensively discuss the exclusive benefit and prohibited transaction rules later. First, however, I would like to address how responsibility regarding investment issues is divided between the Service and the Department of Labor.

ERISA gave Treasury and Labor "mirror image" provisions to administer with respect to many requirements. Under the code, these requirements are enforced either by the disqualification of the plan or by the imposition of excise taxes. Under title I, the remedy is civil action by participants or the Secretary of Labor.

This structure resulted in Labor and the Treasury having overlapping responsibilities in many areas. In 1978, reorganization plan No. 4 eliminated much of this overlap by dividing up primary interpretive responsibility between the two agencies.

Treasury was given primary interpretive responsibility for the minimum participation, vesting and funding rules. Labor was given primary interpretive responsibility for the reporting and for the fiduciary provisions.

Each agency specifically retained enforcement authority with respect to its own law's provisions. Thus, the Service retained authority to enforce the prohibited transaction and exclusive benefit provisions of the code.

This authority, however, is limited by section 103 of the reorganization plan. That section requires the Service to provide Labor with 90 days' notice and an opportunity to concur in or veto the disqualification of a plan which the Service believes may have violated the exclusive benefit rule.

The exclusive benefit rule of the code dates back to 1921. It has been in its present form since 1938. Under the exclusive benefit rule, it must be "impossible under the trust instrument for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries."

Although ERISA did not change the exclusive benefit rule of the code, it did add further requirements and sanctions under the fidu-

ciary rules of title I. Under ERISA, if these fiduciary rules are satisfied, then the standards for the exclusive benefit rule, as set forth in pre-ERISA Revenue Ruling 69–494, are considered satisfied. The most significant investment requisite of Revenue Ruling 69–494 is that the transaction must satisfy the safeguards and diversity to which a prudent investor would adhere.

Virtually all our exclusive benefit cases arise when we examine the operation of employee plans. Often they involve plans where the sole shareholder is either the only participant or has accrued the vast majority of the benefits.

If, in an examination, we find that the investment violation is so pervasive that the plan should be disqualified, we refer the issue to Labor under section 103 of the reorganization plan. The Service has referred about half a dozen cases a year to Labor. Labor has almost always agreed to disqualification or to let the 90 days run without commenting.

The disqualification sanction is not used except in extreme situations. Nevertheless, we expect that as our examination program becomes more extensive, the number of exclusive benefit referrals will increase.

Let me give you some examples of circumstances where we found exclusive benefit violations. They involve:

A plan of a professional corporation that invested 94 percent of the plan's assets in rugs, antiques and other collectibles, and not only that, the professional stored them in his own home;

A plan that lent over 90 percent of assets to the sole shareholder without adequate security, resulting in insufficient assets on plan termination to pay benefits to the other participants; and

A plan of a company owned by three brothers, who were the only participants, that made a 10-percent loan to the company of most of the trust's assets when the prime rate was 21.5 percent.

Chairman PICKLE. Are these three of the six cases?

Mr. POSNER. We do about half a dozen cases a year, and these examples were taken over a period of the last 7 or 8 years.

When the imprudent action involves a prohibited transaction but it is not as pervasive as in the above examples, we do not find that an exclusive benefit violation occurred. Instead, we impose the prohibited transaction sanction, which is targeted at the person undertaking the imprudent action.

Because of the severity of disqualification, ERISA amended the code to provide for a two-tier excise tax. Thus, section 4975 of the code provides for an annual excise tax of 5 percent of the transaction amount. If the transaction is not corrected, there is a 100 percent excise tax. These excise taxes apply only to the qualified plans and can be imposed only by the IRS. They are in addition to any sanctions taken by the Department of Labor under title I of ERISA.

The Department of Labor and the Service both are deeply involved in detecting and remedying prohibited transactions. The IRS–DOL Coordination Agreement, along with several complementary documents, sets forth procedures to assure that the two agencies work together efficiently and smoothly. The agreement calls for exchange of information, detailed check sheets and investiga-

tory reports on referrals and regular field and national office meetings. The idea is to avoid duplication of efforts and examinations.

Prohibited transaction cases are a major component of the Service's examination program. For example, both in fiscal year 1986 and fiscal year 1987, 30 percent of our closed examinations, that is, a 2-year total of 9,000 cases, involved prohibited transactions. These cases generated over $3.6 million in excise taxes on $72 million of violations in fiscal year 1986 and nearly $7 million on $140 million of violations in fiscal year 1987.

Many of the prohibited transaction cases are resolved administratively in the examination process by imposition of the 5-percent excise tax and agreement by the taxpayer to correct the transaction. When we have to litigate, we are quite successful not only in winning the specific cases, but in setting legal precedents.

Here, my testimony cites several instances of litigation where we were successful.

As I indicated, prohibited transaction cases are a major focus of the Service's examination program. Now that we are increasing our examination program, we expect that plan sponsors will become more conscious of the limitations on their use of plan assets. Nevertheless, I am sure we will continue to see a large number of examinations uncovering prohibited transactions.

For many years, the Service has focused its staff efforts on the issuance of determination letters. This was a result of the newness of ERISA and later, as a result of frequent changing of the law. Generally, every time the law has changed, plans had to be amended. Each amendment cycle results in about 700,000 determination letter applications to be processed.

To meet this need, we allocated our staff to handle determination letters. While our determination letter program helps avoid potential problems by assuring that plan language is consistent with the law, our emphasis on determination letters has meant that limited resources have been available to examine operational defects, such as prohibited transactions.

The Service has decided that it must have more of an examination presence. Accordingly, we have targeted 55 percent of available field staff years for examinations. This will be our goal even when the next round of determination letter requests begins.

Already, we can see a stepped-up effort. In May of this year, we had almost 15,000 active cases, up from 6,450 cases at the same time last year.

This increased visibility should also generate more caution and concern among employers and plan administrators. We are hearing concerns, however, that the increased examinations will result in many plans being disqualified.

We recognize why there is a concern among practitioners. Disqualification can be quite harsh. As tax administrators, we would be happy to have alternative sanctions. Not having such alternatives severely limits our flexibility. In his recent draft paper on the philosophy of penalties and other sanctions, the Commissioner made this point in some detail. The exact design of alternative sanctions, however, does need further study.

Finally, I would like to comment on the current status of the Central States Teamsters pension fund. As you know, this is one of

the largest funds in the country with almost $8 billion in assets, almost a half-million participants and about 9,000 contributing employers.

IRS revoked the fund's exempt status in 1976 because it found that there were widespread mismanagement of assets and gross abuses by the trustees of their fiduciary duties. The controversies surrounding the fund's loss of exemption resulted in a number of congressional hearings, including those of this subcommittee, and was the catalyst for much-needed reforms that have taken place since then.

The fund's exempt status was restored in 1977, conditioned, among other things, on the fund's transfer of most of its assets to independent asset managers. Also, the old trustees resigned and new trustees were appointed. The Government, however, continued to closely monitor the fund.

Although the fund has made sweeping reforms, it is likely the IRS will continue to monitor the fund's activities. The Government's actions were, in my opinion, a major factor in the significant reforms that were achieved. I believe that our continuing interest will be a strong incentive for the fund to maintain these reforms.

Currently, the fund has a request pending in our Chicago District Office for a determination letter with respect to amendments made to comply with pension legislation. They forwarded a proposed favorable letter to the fund on June 3, 1988, which continues the asset management conditions of the prior letters. We expect that this letter will be finalized in the very near future.

Mr. Chairman, this completes my testimony. I hope the information I provided today is helpful to you. At this time, I will be happy to answer any questions that you have.

Chairman PICKLE. We thank you, Mr. Posner, and we will proceed with the next witness and then come back to questioning for both of you.

[The statement of Mr. Posner follows:]

STATEMENT OF WILLIAM POSNER, ASSISTANT DIRECTOR,
EMPLOYEE PLANS TECHNICAL AND ACTUARIAL DIVISION,
INTERNAL REVENUE SERVICE

Mr. Chairman and Members of The Subcommittee:

My name is William Posner. I am the Assistant Director of the Employee Plans Technical and Actuarial Division of the IRS. With me is Stuart Sirkin, Special Assistant to the Assistant Commissioner for Employee Plans and Exempt Organizations.

I am here today to testify on the exclusive benefit rule of section 401(a)(2) of the Internal Revenue Code and the prohibited transaction rules of section 4975. These requirements are at the heart of the Service's efforts to assure that investments by qualified retirement plans are consistent with the objectives of ERISA. Also, I would like to discuss our expanding employee plans examination program and the sanctions available to the Service. Finally, I will provide an update on the status of the Central States Teamsters Fund.

Background

I will begin by reviewing the role of the Service with respect to qualified retirement plans. When a pension, profit sharing or stock bonus plan satisfies the requirements of section 401(a) of the Code, it is referred to as a "qualified plan." Although an employer is not required to establish and maintain a qualified retirement plan (or any retirement plan), the Code provides an employer with substantial tax incentives to do so. For example, employer contributions to such plans are, within broad limits, fully deductible when made; the earnings of any related trust funds are tax exempt; employees are not taxed on the retirement benefits until plan distributions are actually made; and certain distributions are eligible for special tax treatment.

Favorable tax treatment is expressly conditioned upon the plan meeting, both in form and in operation, the qualification standards set forth in section 401(a) of the Code. These qualification standards require, among other things, that the plan does not discriminate in favor of highly compensated employees, that contributions and benefits are limited in amount and that minimum participation and vesting standards are satisfied. They also require that the plan be for the exclusive benefit of employees and their beneficaries.

Also, a qualified plan is prohibited from making investments, or otherwise dealing, with certain people or entities, i.e. from engaging in prohibited transactions.

I will more extensively discuss the exclusive benefit and prohibited transaction rules later. First, however, I would like to address how responsibility regarding investment issues is divided between the Service and the Department of Labor.

Responsibility

ERISA gave Treasury and Labor "mirror image" provisions to administer with respect to many requirements. Under the Code (Title II of ERISA), these requirements are enforced either by the disqualification of the plan or by the imposition of excise taxes. Under Labor's title (Title I), the remedy is civil action by participants or the Secretary of Labor.

This structure resulted in Labor and the Treasury having overlapping responsibilities in many areas. In 1978, Reorganization Plan No. 4 eliminated much of this overlap by dividing up primary interpretive responsibility between the two agencies. Treasury was given primary interpretive responsibility for the minimum participation, vesting and funding rules. Labor was given primary interpretive responsibility for the reporting and fiduciary provisions, including primary responsibility for interpreting plan investment rules and for issuing individual and class exemptions from the prohibited transactions provisions.

Each agency specifically retained enforcement authority with respect to its own law's provisions. Thus, the Service retained authority to enforce the prohibited transaction and exclusive benefit provisions of the Code. This authority, however, is limited by section 4975(h) of the Code and section 103 of the Reorganization Plan, respectively. Section 4975 requires the Service to notify the Secretary of Labor before sending a notice of deficiency with respect to the prohibited transactions excise taxes. Section 103 of the Reorganization Plan requires the Service to provide Labor with 90 days notice and an opportunity to concur in or veto the disqualification of a plan which the Service believes may have violated the exclusive benefit rule.

Exclusive Benefit Rule

The exclusive benefit rule of the Code dates back to 1921. It has been in its present form since 1938. Currently, section 401(a)(2) of the Code provides that:

> "a trust forming part of a stock bonus, pension, or profit-sharing plan for the exclusive benefit of some or all of the employees. . . [is not exempt unless] it is impossible . . . for any part of the corpus or income to be. . . used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries...."

Although ERISA did not change the exclusive benefit rule of the Code, it did add further requirements and sanctions under the fiduciary rules of Title I. Under ERISA, if these fiduciary rules are satisfied, then the standards for the exclusive benefit rule, as set forth in pre-ERISA Rev. Rul. 69-494, are considered satisfied. Thus, to satisfy the exclusive benefit rule, the investment cost cannot be greater than its fair market value; there must be a fair return commensurate with the prevailing rate; there must be sufficient liquidity; and the transaction must satisfy the safeguards and diversity to which a prudent investor would adhere.

The law is clear that the Service may, in coordination with Labor, disqualify plans for exclusive benefit violations. Despite this clarity, the continuing viability of the exclusive benefit rule was a defense argument in Winger's Department Store v Comm., 82 T.C. 869 (1984). Winger's involved a pension plan which, in essence, made a series of unsecured loans to the employer equal to the amount of the employer's contributions to the plan for the year. The employer then made equal unsecured loans to the sole shareholder.

The defendent in Winger's argued that in light of ERISA, disqualification was not the proper remedy. The court rejected this argument. It held that Title I of ERISA and the prohibited transactions excise taxes were compliments to, not substitutes for, disqualification. The court also cited the Reorganization Plan as reemphasizing this point.

Exclusive Benefit Examinations

The fact situation in Winger's is typical of the type of case in which we find exclusive benefit violations. Virtually all our exclusive benefit cases arise when we examine the operation of employee plans. Often they involve plans where the sole shareholder is either the only participant or has accrued the vast majority of the benefits. That is not to say that there are no cases that impact on rank and file workers; but violations by a large plan are usually not so pervasive as to warrant disqualification.

Typically, exclusive benefit issues do not arise in the determination letter process because virtually all plans use language to the effect that "assets may not be used for or diverted to purposes other than the exclusive benefit of employees or their beneficiaries." Plans also generally provide that fiduciaries have wide discretion with respect to investments. Thus, the investment issues are left for examinations.

If in an examination we find that the investment violation is so pervasive that the plan should be disqualified, we refer the issue to Labor under section 103 of the Reorganization Plan, as discussed above. The Service has referred about half a dozen cases a year to Labor. Labor has almost always agreed to disqualification or let the 90 days run without commenting. The disqualification sanction is not used except in extreme situations. Nevertheless, we expect that as our examination program becomes more extensive, the number of exclusive benefit referrals will increase.

As I indicated, most of these cases have involved small plans, frequently with the employer being the sole shareholder and only participant. Sometimes, however, the disqualification sanction has the additional effect of adversely impacting rank and file workers. We are very conscious of this and, wherever possible, look for alternatives to protect the rank and file. For example, in the Central States Teamsters case, which I will discuss later, disqualification would have involved hundreds of thousands of rank and file workers. In that case, under section 7805(b) relief authority, we provided the plan with an alternative to disqualification that would protect rank and file workers. Under this alternative, the innocent participants not responsible for the imprudent practices of the plan fiduciaries were protected; while major reforms demanded by the government were made in the plan's operation.

Investment violations must be quite pervasive to result in disqualification of a plan. Let me give you some examples of circumstances where we found exclusive benefit violations:

- a plan of a professional corporation that invested 94% of the plan's assets in rugs, antiques and other collectibles and "stored" them at the home of the sole shareholder;

- a plan that made unsecured loans amounting to 64% of the plan's assets to the bankrupt employer, resulting in the average amount of the rank and file workers' account balances declining over a short period of time from $4000 to about $1000;

- a plan that received as contributions the firm's questionable accounts receivable; the plan trustees did not try to collect the accounts when payments were made directly to the firm, resulting in insufficient assets for distributions to the employees;

- a plan that lent over 90% of its assets to the sole shareholder without adequate security, resulting in insufficient assets on plan termination to pay benefits to the other participants; and

- a plan of a company owned by 3 brothers, who were the only participants, that made a 10% loan to the company of most of the trust's assets when the prime rate was 21 1/2%.

When the imprudent action involves a prohibited transaction but it is not as pervasive as in the above examples, we do not find that an exclusive benefit violation occurred. Instead, we impose the prohibited transaction sanction, which is targeted at the person undertaking the imprudent action.

Prohibited Transactions

Prior to ERISA, a trust was disqualified if a prohibited transaction occurred. Because of the severity of disqualification, ERISA amended the Code to provide for a two-tier excise tax. Thus, section 4975 of the Code provides for an annual excise tax of 5% of the transaction amount. If the transaction is not corrected, there is a 100% excise tax. These excise taxes apply only to qualified plans and can be imposed only by the IRS. They are in addition to any actions taken by the Department of Labor under Title I of ERISA.

Labor may bring a civil action under ERISA against the fiduciary engaging in the prohibited transaction. Labor also can refer the case to the Service to assess the excise tax.

As can be seen, Labor and the Service both are deeply involved in detecting and remedying prohibited transactions. The IRS-DOL Coordination Agreement, along with several complimentary documents, sets forth procedures to assure that the two agencies work together efficiently and smoothly. The Agreement calls for exchanges of information, detailed checksheets and investigatory reports on referrals and regular Field and National Office meetings. The idea is to avoid duplication of efforts and examinations. The meetings are intended to iron out past problems

and avoid new ones. Experience has taught us that when the two agencies coordinate in the field and in Washington, many problems can be quickly worked out. Both agencies are committed to continually improving this coordination.

Labor referrals represent only a small portion of the prohibited transaction cases in which the Service is involved. Indeed, prohibited transaction cases are a major component of the Service's examination program. For example, both in FY 1986 and FY 1987, 30% of our closed examinations, i.e., a two-year total of almost 9000 cases, involved prohibited transactions. These cases generated over $3.6 million in excise taxes on $72 million of violations in FY 86 and nearly $7 million on $140 million of violations in FY 1987.

Prohibited transaction cases frequently involve transactions between the employer and its plan. While they occur in both large and small plans, they are a particular problem in the small plans where the employer is also the plan fiduciary and uses the plan as his or her personal bank for, as an example, a business loan.

Many of the prohibited transaction cases are resolved administratively in the examination process by imposition of the 5% excise tax and agreement by the taxpayer to correct the transaction. When we have to litigate, we are quite successful not only in winning the specific cases but in setting legal precedents.

See, for example, Hockaden & Assoc. v. Comm., 800 F. 2d 70 (6th Cir. 1986) (pre-ERISA loans that continue post-ERISA are not grandfathered); Lambos v. Comm., 88 T.C. No. 80 (1987) (upheld regulation's calculation of tax imposed on leases and loans); and Leib v. Comm., 88, T.C. No. 83 (1987) (transaction is not exempt just because it is prudent and benefits the plan, and correction is required).

The most recent case is Rutland v. Comm., 89 T.C. No. 80 (1987). In Rutland, corporate officers, directors and employees who were participants in a plan sold property to the plan for cash and a promissory note. The plan then leased such property to the corporation.

In addition to finding this a prohibited transaction, the court held that:

- multiple prohibited transactions may arise out of a single loan or purchase of property, thereby generating separate 5% excise taxes; e.g. lease and loan transactions are new prohibited transactions as of the beginning of each year and the purchase of property and the concurrent issuance of a note with respect to the property are separate prohibited transactions;

- a prohibited transaction remains as such even though the disqualified person who entered into the transaction would not otherwise be a disqualified person in a future year; and

- good faith or lack of harm to the plan are not relevant in determining whether a prohibited transaction occurred.

As I indicated, prohibited transaction cases are a major focus of the Service's examination program. Now that we are increasing our examination program, we expect that plan sponsors will become more conscious of the limitations on their use of plan assets. Nevertheless, I am sure we will continue to see a large number of examinations uncovering prohibited transactions.

EXAMINATIONS

For many years the Service has focused its staff efforts on the issuance of determination letters. This was a result of the newness of ERISA and later as a result of the frequent changes of the law. Generally, every time the law has changed, plans had to be amended. Each amendment cycle results in about 700,000 determination letter applications to be processed.

To meet this need, we allocated our staff to handle determination letters. While our determination letter program helps avoid potential problems by assuring that plan language is consistent with the law, our emphasis on determination letters has meant that limited resources have been available to examine operational defects, such as prohibited transactions.

The Service has decided that it must have more of an examination presence. Accordingly, we have targeted 55% of field staff years for examinations. This will be our goal even when the next round of determination letter requests begins. We will be able to do this for several reasons. First, our Employee Plans staff has increased. The field offices are authorized 1,025 Employee Plans technical staff years in FY 88 compared to 912 staff years in FY 87 and 851 staff years for FY 86.

Second, we are taking steps to more efficiently handle our determination letters. For example, we are encouraging employers to participate in the master and prototype plan program, the volume submitter field program and other programs that we are developing that do not require us to review in detail every plan. We are also taking steps to encourage employers to come in early so that submissions will be spread out and not all received on the last possible day.

Already we can see a stepped-up effort. In May of this year, we had almost 15,000 active cases, up from 6,450 cases at the same time last year. These examinations are not limited to exclusive benefit and prohibited transactions issues, but also focus on other types of issues such as valuation of securities in ESOP transactions. Because examinations are generally on returns filed in prior years, we do not currently have information on specific instances where plans were affected by the stock market drop.

Examinations generate more litigation than determination letters; thus, we can expect to see a substantial increase in the amount of litigation in the near future. In recognition of this, the Chief Counsel has just designated a National Office Employee Benefit Counsel to coordinate these efforts.

This increased visibility should also generate more caution and concern among employers and plan administrators. The increase in examinations makes it easier for practitioners to be persuasive when they say to their clients "no, this is not allowed" because they can point to enforcement actions taken by the Service in similar cases. We are hearing concerns, however, that increased examinations will result in many plans being disqualified.

We recognize why there is a concern among practioners. Disqualification can be quite harsh. As tax administrators, we would be happy to have alternative sanctions. Not having such alternatives severely limits our flexibility. In his recent draft paper on the philosophy of penalties and other sanctions, the Commissioner made this point in some detail. The exact design of alternative sanctions, however, needs further study. In the 1986 Tax Reform Act, we saw the nature of the sanction for coverage violations changed from disqualfication to a tax on the highly compensated employees. We have also seen additional excise taxes added to the Code. Further study along these lines needs to be pursued. The Service has a great interest in seeing a more effective sanction structure. I hope we can work closely with you in pursuing appropriate alternatives.

Central States Teamsters

Finally, I would like to comment on the current status of the Central States Teamsters Pension Fund. As you well know, this is one of the largest funds in the country with almost $8 billion in assets, almost half million participants and about 9,000 contributing employers.

IRS revoked the Fund's exempt status in 1976 because it found that there were widespread mismanagement of assets and gross abuses by the trustees of their fiduciary duties. The controversies surrounding the Fund's loss of exemption resulted in a number of Congressional hearings, including those of this Subcommittee, and was the catalyst for much needed reforms that have taken place since then. The Fund's exempt status was restored in 1977, conditioned, among other things, on the Fund's transfer of most of its assets to independent asset managers. Also, the old trustees resigned and new trustees were appointed. The government, however, continued to closely monitor the Fund.

Although the Fund has made sweeping reforms, it is likely the IRS will continue to monitor the Fund's activities. The government's actions were, in my opinion, a major factor in the significant reforms that were achieved. I believe that our continuing interest will be a strong incentive for the Fund to maintain these reforms.

Currently, the Fund has a request pending in our Chicago District Office for a determination letter with respect to amendments made to comply with pension legislation. The Chicago Office forwarded a proposed favorable letter to the Fund on June 3, 1988, which continues the asset management conditions of the prior letters. We expect that this letter will be finalized in the very near future.

Conclusion

I hope the information I provided today will be helpful to you. If you require any further information, we would be glad to provide it. We would be happy to answer any questions you might have.

Chairman PICKLE. Now, Mr. Lebowitz, if you will proceed.

STATEMENT OF ALAN D. LEBOWITZ, DEPUTY ASSISTANT SECRETARY FOR PROGRAM OPERATIONS, PENSION AND WELFARE BENEFITS ADMINISTRATION, U.S. DEPARTMENT OF LABOR

Mr. LEBOWITZ. Thank you very much, Mr. Chairman. Good afternoon, Mr. Chairman and members of the committee.

I am Alan Lebowitz, Deputy Assistant Secretary for Program Operations of the Labor Department's Pension and Welfare Benefits Administration. With me here today is Charles Lerner, Director of Enforcement of the Administration. I am pleased to testify today on the rules governing investments by private pension plans under the Employee Retirement Income Security Act of 1974, otherwise known as "ERISA."

Consistent with your oversight responsibilities, I will discuss the rules governing fiduciary responsibilities under ERISA and how we enforce those rules. I will also address the possible effect of last year's stock market drop on the financial integrity of private pension plans and its implications for the retirement security of America's workers.

Congress enacted ERISA to assure America's workers that their employers' pension promises were not empty gestures. It sought to accomplish this goal in two ways. First, ERISA contains reporting and disclosure requirements. These rules help workers understand the nature of the promise made to them, the financial status of their plans and their right to initiate legal action to protect their interests. ERISA requires that information about pension plans be filed with the Federal Government, which uses the information for enforcement, planning and research. The Labor Department makes this information available to the public.

Second, ERISA significantly enhanced the likelihood of workers actually receiving their promised benefits. Participation and vesting rules prevent pension plans from unfairly excluding employees from a pension plan and require that a participant have a nonforfeitable right to a benefit after a stated period of time. Minimum funding provisions were established for defined benefit plans, mandating that contributions be set aside to pay future benefits. In addition, the Pension Benefit Guaranty Corporation, PBGC, was established by ERISA to ensure the payment of certain benefits under defined benefit plans in the event of plan termination.

Finally, rules governing fiduciary responsibility were enacted for all plan trustees, administrators, investment managers and others responsible for investing the assets of ERISA-covered plans. These rules assured that plan fiduciaries would be subject to uniform, stringent requirements to protect the plan's assets. Congress provided the Labor Department with broad enforcement powers in this area, including the ability to seek both civil and criminal sanctions. Plan participants and beneficiaries were also given the right to bring civil action under Federal law for fiduciary breaches of duty.

ERISA created a variety of rules, derived from the common law of trusts, to guide the behavior of ERISA plan fiduciaries. Because the assets of pension plans are held and managed for the benefit of

employees, many trust law principles were adopted for pension plan fiduciaries. For example, ERISA generally provides that plan assets must be held in trust and that the trustees are, with limited exceptions, exclusively responsible for the management of plan assets. ERISA also requires that plan fiduciaries act solely in the interests of the plan participants and beneficiaries. This rule is derived from the duty of loyalty under the common law of trusts.

ERISA modified some of the common law rules, however, to help achieve the special aims of private pension plans. Thus, plan investments under ERISA must be made with the care, skill, prudence and diligence that a prudent person familiar with such matters would make under similar circumstances. Investments of ERISA plan assets must be diversified, unless it is prudent not to diversify. The determination of whether a particular investment is prudent can only be made in the context of the facts and circumstances existing at the time the investment decision is made. The Labor Department's regulations provide that prudence is measured in an economic sense and that determination of whether an investment is prudent is made by considering all of the investments in the plan's portfolio.

The prudence rule, derived from the common law of trusts, was modified to take into account the special nature of employee benefit plans. This rule, as formulated under ERISA, is flexible and based on economic reality, enabling plan fiduciaries to make investments in the best interests of the plan in light of changing economic conditions and new investment opportunities.

In addition to these broad guidelines, Congress enacted certain specific prohibitions. These rules prohibit plans from engaging in transactions where an insider relationship exists or where the fiduciary's independent judgment may be impaired because of improper influence or a conflict of interest.

For example, a fiduciary may not cause the plan to participate in a loan of money or a sale of property with the employer or labor union which established the plan. Nor may a fiduciary allow a plan to engage in a transaction that would result in self-dealing or receipt of consideration by the fiduciary from a third party.

The act contains a number of statutory exceptions from these prohibitions to allow customary and necessary business practices. For example, an exemption exists for plan loans to participants if they are available on a nondiscriminatory basis. In addition, the Department of Labor has the authority to issue administrative exemptions from ERISA's prohibited transactions. The Department may issue an exemption only if the exemption is administratively feasible, is in the interest of the plan and its participants, and is protective of the rights of the participants and beneficiaries. As originally enacted, this was an area of overlapping jurisdiction with the IRS. Reorganization plan No. 4 of 1978, however, generally allocated exemption authority to the Department of Labor.

The Labor Department has the enforcement authority to seek all appropriate equitable relief to remedy violations of ERISA's fiduciary rules. Our jurisdiction in this area covers over 900,000 pension plans and approximately 4.5 million welfare benefit plans.

These pension plans covered an estimated 62 million participants in 1987, or slightly more than half of all full-time workers in Amer-

ica. Approximately 9 million retirees currently receive benefits from ERISA-covered pension plans.

You may be interested to know how we have carried out our duties in enforcing ERISA's fiduciary responsibility rules. Our total enforcement staff of 266 may appear small when compared to the number of plans we regulate and we cannot review every plan on a regular basis. In carrying out our enforcement responsibilities, we have formal and informal arrangements for exchanges of information and referrals of cases with the IRS, SEC, Justice Department and five Federal bank regulatory agencies, as well as with a number of similar State agencies around the country. We also refer appropriate cases to the Department of Labor's Office of Labor Racketeering in the Inspector General's Office and the Inspector General conducts reviews and analyses of ERISA investigations.

We adopted an enforcement strategy in 1986 that allocated our enforcement resources in what we believe is an effective and efficient manner. This enforcement strategy implementation plan dedicates 50 percent of our investigative staff time to cases involving significant issues.

We presently have two such issues which receive priority attention. First, we focus on institutional fiduciaries, that is, those who have the responsibility of managing the assets of large numbers of plans. These are typically broker-dealers, financial institutions, and insurance companies. The second area of emphasis involves persons who provide services to the plans or their participants, including plan administration or dental care services. The effect of the significant issue strategy is to bring cases that affect a substantial number of plans which use the same fiduciary or service provider, and thereby leverage the impact of our available resources.

The remaining 50 percent of our investigative time is available for more broadly based matters. These cases are opened in all geographic regions, affect both large and small plans, and are based upon a variety of sources, including participant complaints, public reports, and analysis of data from the annual reports on the ERISA Form 5500 which is filed with the Federal Government.

As you may know, we and the IRS are in the process of creating an automated system for handling information reported on the annual form 5500. This data base will be implemented using data from the form 5500s filed for the 1988 plan year. In that regard, we are modifying the form's content and developing a system of targeting data to best utilize our resources. It is anticipated that the new ERISA automated data base management system will greatly enhance our effectiveness in both significant issue and other cases.

A case that illustrates the utility of ERISA's fiduciary rules in protecting plan participants involves a matter of long-standing interest to you, Mr. Chairman. I am referring to the management of the Teamsters' Central States pension and health and welfare funds. We remember your early efforts in pursuing the improprieties in those funds quite well. Your efforts in protecting the interests of its participants and beneficiaries is appreciated and should be acknowledged.

We are pleased to report that ERISA's broad remedies have helped us recover over $21 million for the participants and beneficiaries of the Teamsters' Central States pension and health and

welfare funds in a series of lawsuits brought against plan fiduciaries and affiliated parties in interest. Equally important, a judicially enforceable consent decree requires the independent professional management of the pension fund assets until at least the year 2002. A parallel decree entered by the Federal Court in Chicago required the independent management of the health and welfare fund through at least 1995. The court monitors the activities of both funds through an independent special counsel who regularly reports to the court.

In a related case, *M&R Investment & Company, Inc.* v. *Fitzsimmons,* the court agreed with the Labor Department in finding that ERISA's prohibited transaction rules prevented the Central States Teamsters pension fund from lending $40 million to the owners of the Dunes Hotel in Las Vegas. In this case, the prohibited transaction rules were utilized to prevent what may well have been an imprudent loan of plan assets. This action protected the plan from the risk of potentially large losses.

With regard to our overall activities, our enforcement efforts have been increasingly successful in terms of monetary recoveries. In 1987, we restored more than $117 million in plan assets. More than $77 million of this total was obtained through voluntary compliance efforts which did not require litigation. Monetary requirements in 1986 totaled over $77 million, and in 1985, we recovered more than $51 million. With regard to the number of cases handled by our Office of Enforcement, we closed 1,758 in fiscal 1987 and 1,687 cases in fiscal 1986.

In addition to our Office of Enforcement, we also maintain a technical assistance unit which helps plan participants obtain benefits to which they are entitled under their plans. We do not do this as the participants' representative, but rather to try to help the parties themselves get together to see if an agreement is possible. In 1987, the technical assistance program achieved the milestone of helping participants obtain $25 million in benefits since 1980. Annual benefits obtained with the help of the technical assistance program totaled $4.4 million in 1987, $6.1 million in 1986, and $2.5 million in 1985. We have also seen an increase in the number of inquiries handled by the technical assistance program, from 27,000 in fiscal 1986 to over 33,000 in fiscal year 1987.

I would like to turn now to a discussion of the effect of last October's stock market drop on ERISA-covered pension plans. I understand that you will be hearing from several experts on the short-term financial effects of October 1987, so I will discuss this only briefly. Let me mention a few relevant statistics at the outset.

Approximately $1.6 trillion was held in ERISA covered pension plans in 1987. Two-thirds of this total was represented by defined benefit plan assets. ERISA's rules governing plan investments require diversification of plan assets to minimize the risk of large losses. A typical portfolio of a large plan would include not only stocks, but also bonds, cash and perhaps some real estate and other holdings. Pension funds typically invest about 40 percent of their assets in direct equity holdings. While equity holdings may have been affected by the market drop, our preliminary research indicates that the diversification of pension fund portfolios insulated

most plans from losses of the magnitude suffered by the Dow Jones average.

Although investing in stocks may present short-term risks, there appears to be a consensus among economists that investors who remain in the market over the long term, as is typical with pension funds, are generally unharmed by market fluctuations. As a general matter, while equity investments are subject to short-term market fluctuations, over the long term they provide greater returns than more conservative investments.

Participants in defined benefit pension plans, in particular, are less affected by market fluctuations. This is because their promised benefit is a defined amount, often based on factors such as years of service and salary which are unaffected by market fluctuations.

The plan sponsor generally bears the risk that, if the return on plan investments is less than anticipated, it must increase contributions to the plan. In addition, the Pension Protection Act of 1987 makes plan sponsors fully accountable and liable for all promised benefits.

Defined contribution plans and the participants are, however, more directly affected by fluctuations in the value of assets. This is because defined contribution plan participants receive the value of their individual accounts at retirement. Obviously, the amount that an individual retiree in a defined contribution plan would receive would be directly affected by the value of the assets in his or her account. Thus, the October 1987 stock market drop reinforces the wisdom of diversifying investments, especially in the case of defined contribution plans.

It should be stressed that neither type of pension plan is designed to be invested for short-term results. It is our position that fiduciaries who are responsible for plan assets must consider the long-term results of their investment decisions.

For many defined contribution plan participants, the drop in stock prices between August and October of 1987 was offset by the unprecedented 5-year rise in prices before the downturn and by the subsequent recovery of prices on the stock market.

At this time, we have no reliable data indicating that the market downturn had a significant adverse effect on participants in either defined benefit or defined contribution plans. In fact, the amount of net excess assets in defined benefit plans at the end of 1987 was greater than the amount of net excess assets at the end of 1986: $248 billion versus $218 billion.

In conclusion, the Department believes that pension payments from private pension plans with diversified investments and adequate funding have not been unduly threatened by the stock market downturn of late 1987. We look forward to the new ERISA data base project, which will computerize the storage and retrieval of information reported on the annual reports of pension plans. We will be receiving more timely and useful financial information regarding plan investments. The data base project should result in more reliable data and easier retrieval for targeting possible violations of ERISA's fiduciary rules in plan investments. Of course, if we discover improper investment practices, either from the data base project or under our current methods as the 1987 annual reports are filed, we will not hesitate to consider such cases for inves-

tigation and enforcement to recover plan assets for participants and beneficiaries.

Thank you, Mr. Chairman. I will be happy to answer any questions that you might have at this time.

Chairman PICKLE. Thank you.

Now, Mr. Posner, you said that the Service has decided that it should have more examinations. You are going to step it up. And you have targeted 55 percent of available field staff for examination. Does that mean that over half of your examinations now would be increased by more than half, and double the amount of people in it as examiners?

Mr. POSNER. No. It doesn't mean double the amount. What it does mean is that of our available resources, we are roughly splitting our staffing between the determination letter process and the examination process, giving a little extra emphasis to the examination process.

We had roughly, as I recall, about 15 percent of our available resources devoted to examinations before that. So, the step up is the difference between 55 and 15 percent.

Chairman PICKLE. You said in May of this year, you had almost 15,000 active cases, and that was an increase from about 6,450 cases last year. And then you say, we recognize why there is concern among practitioners. You expressed the fact that there is concern. Is there a problem in this field? Who says there is concern?

Mr. POSNER. Well, we have heard from practitioners in conferences and meetings that we attend. The requirements for qualification, as you know, Mr. Chairman, are quite complex. There are many different rules. And I am not just talking about the exclusive benefit rule here, but I am talking about all of the different rules, including participation and vesting, the antidiscrimination rules, and the joint and survivor rules.

And the violation of any of these rules results in disqualification. Now, often disqualification of a plan hurts the very people that the statute meant to protect. Disqualification is not really an appropriate sanction in all cases. What we think is needed are alternative sanctions in certain cases that will not penalize the innocent employees for some of these violations.

Chairman PICKLE. Let me see if I can get this in perspective. How many pension plans did the IRS examine last year?

Mr. POSNER. In fiscal year 1987, the IRS examined 8,700 returns of plans.

Chairman PICKLE. 8,700 plans, I see. Now, all right, how many plans do you have in this country?

Mr. POSNER. There are, including the one-participant plans, approximately 1.5 million plans.

Chairman PICKLE. All right. You have examined, then, 8,700 out of 1½ million plans, is that correct?

Mr. POSNER. Yes, that is correct.

Chairman PICKLE. Now, that would mean that each examiner would examine how many in a year's time? What would that figure be?

Mr. POSNER. Are you asking for the percentage?

Chairman PICKLE. Yes, what percentage, or number. I am trying to see—you have over 1 million plans.

Mr. POSNER. It is less than 1 percent.

Chairman PICKLE. Less than 1 percent. Well, now, tell me then, in relation to that, if you are going to step up your examination number, what does a 55-percent increase mean now in relation to those plans?

Mr. POSNER. In terms of numbers of examinations, we right now are going at an annual rate of about 16,500 plans, and we are in a transition period now, so we would expect to get above 20,000 plans.

Chairman PICKLE. Don't I have to assume, Mr. Posner, that if you are only examining less than 1 percent, then you just don't look at 99 percent of them, because you don't have the manpower, or you are not concerned, or you think they are in good shape, or you are just hoping and praying that they are in good shape? Which is it?

Mr. POSNER. Well, Mr. Pickle, it does seem like a very low percentage. However, I would point out that we have some very sophisticated techniques for identifying the kinds of plans that need to be examined. What we do is when a form 5500 series return is filed, it is rated according to its profile and given a DIF or discriminant function score.

Many of the plans, on the basis of those being filed, are very clean plans.

Many of them have a very small amount of assets or are inactive plans. So that the plans that we do examine are those with the highest potential for finding violations.

Chairman PICKLE. All right. You have got a pattern, and you have a model, and you have techniques. I am sure that you could detect a lot of things by that method. But if you examine less than 1 percent of these plans, are you doing a much more effective job than the IRS does in monitoring individuals? We monitor or we review anyone from 1 to 2 percent of the regular income cases, and that is examination on income of an individual to see if he has done it right or not. Here you have plans where you have pensioners who have money invested.

It seems to me that is totally inadequate, and you don't know whether those plans are there or not, or whether proper procedure is being followed. I am not accusing you of that, but, it seems to me like you are starting to realize there's a problem when you have such a small number actually being reviewed. How many did you revoke last year?

Mr. POSNER. I do not have the statistics on that. It was a very low number, and the reason for that is that——

Chairman PICKLE. What is a low number?

Mr. POSNER. Perhaps less than 100.

Chairman PICKLE. Less than 100?

Mr. POSNER. Yes. I would like to have that list submitted to the committee.

[The following was subsequently received:]

REVOCATIONS

In the 36 month period ending in June 1988, there were 260 revocations involving 171 plans (some plans were revoked for more than one year).

Of the plans revoked, 127 were defined contribution plans and 44 were defined benefit plans. The number of participants in the revoked plans are as follows:

PARTICIPANTS

Defined contribution plans (DC):	*Number of plans*
1	31
2 to 5	69
6 to 10	13
11 to 25	11
26 to 99	2
100+	1
Total (DC)	127
Defined benefits plans (DB):	
1	16
2 to 5	17
6 to 10	3
11 to 25	2
26 to 99	6
100+	0
Total (DB)	44
Total (DC+DB)	171

Mr. POSNER. I would point out in addition to the examination program, we have the determination letter program which is a compliance program. This program is designed to assure that plans, up front, meet the requirements of the code as to form; and once the plan administrator and employer know what the rules are, if they follow the terms of the plan, they are likely to be in compliance with the law.

We do assume that most people voluntarily comply once they know what the rules are, and so the determination letter program is also a very valuable compliance program.

Chairman PICKLE. I'll make a further observation, and then I'll yield to you, Mr. Anthony. There are pension assets of $1.6 trillion. To me, that means any given day or on a rolling basis throughout the year or at the end of the year, plans have got $1.6 trillion to invest.

Now, that makes the private pension plan almost bigger than the government itself. That means these fiduciaries and the trustees have in their hands more power than all the banks put together nearly. Whether that is so or not so is your own assumption. But, it is an alarming amount of money when you combine the assets. It is almost as large as the national debt itself.

Now, I would think, with that huge amount of money being invested, that there would be a closer check on these plans to be certain that the fiduciary obligations are being followed and that indeed the money would be there. Are you satisfied that proper surveillance is being made, that proper examination is being made? And, you are not concerned about the development of this pension program?

Mr. POSNER. Well, sir, I am always concerned about the plans in operation. I think that it is just simply not possible to do examinations for very large percentages. As you know, once you get into larger amounts, you reach a point of diminishing returns. The important thing is to have an examination presence to be sure that

the public is aware that there is a viable examination program so that those who are the most aggressive and those who are taking advantage are likely to be examined, and that is a program that we are moving to.

As I said, we do need a greater examination presence. I certainly agree with you on that, and we are moving to do that.

Chairman PICKLE. Well, I am hoping a little later we can get into some questions on pension investments, on where they are putting the money. Can I, as an individual, go down the street at any given place and find out where every fund has invested their dollars, where that money is, how it is invested?

Mr. POSNER. Well, the forms 5500 are available for public inspection, and so it is possible to tell the types of investments that are made with particular funds.

Chairman PICKLE. Well, the form 5500 is about the only audit or only kind of review we have of it. I don't know of any place, though, where we can find out where this money is being invested; how it has been invested; or whether it is in stocks or bonds or insurance or equities or other forms. If there is some place, to know where to go get it, I want you to tell me, other than possibly through the 5500. Is there any other place we can get that information? If the Washington Post wanted to know where this $1.6 trillion was invested, could they find out?

Mr. LEBOWITZ. My guess is if the Washington Post were interested in that question, they would ask us, and we would get the information from——

Chairman PICKLE. Let's suppose they ask you. Let's say they ask you. What would you say to them?

Mr. LEBOWITZ. Well, we extract the data that is submitted to us on the forms 5500 which contains a great deal of detail about particular investments.

Chairman PICKLE. A 5500 gives a clear picture about how these assets are invested on a regular basis, an ongoing basis?

Mr. LEBOWITZ. Yes, sir, it would.

Chairman PICKLE. A 5500 is sufficient then?

Mr. LEBOWITZ. The 5500 for those plans that have 100 or more participants is a very extensive form, and it contains very elaborate and detailed information concerning the financial activities of the plans, including the precise investments that a particular plan has entered into. There is less information available for smaller plans.

Chairman PICKLE. I want to yield to Mr. Anthony. I want to come back to this. I have got to excuse myself for a minute. If there is a place for me to go get information where this $1.6 trillion is invested, what balance they have, where they are controlled, I don't know where it is. And, I don't think anybody who is a worker who has his pension fund involved, that he would know either exactly where those funds were being invested and what shape they are in.

Mr. LEBOWITZ. Mr. Chairman, we have a fairly elaborate and extensive research program at the Department that seeks to try to answer those kinds of questions. It also seeks to try to maintain data off of the 5500 and extrapolate from the information about

how pension funds are being invested, in what kinds of particular investment vehicles and what their funding status is.

Chairman PICKLE. I am going to get back to that 5500 in a minute.

Mr. Anthony, I will have to ask you to take over at this point.

Mr. ANTHONY [presiding]. I think I have your trend line, and I want to come back to Mr. Posner and ask him questions about it. However, I would like to clarify your testimony, Mr. Lebowitz. Over the last 5 years, what would be the trend line in terms of the number of cases that the Department of Labor has examined?

Mr. LEBOWITZ. Over the past 5 years, the number has increased. I don't think I have the precise statistics for the 5-year period. But, for example, in 1986, for the fiscal year 1986, we conducted 1,640 investigations. For fiscal year 1987, that number was 1,733.

I might point out too that an investigation, the unit that we count to determine our level of productivity, is not necessarily the same unit that the IRS counts in determining examinations. Investigation generally involves a fairly intensive look at all aspects of, not of a particular plan necessarily, but it may involve and often involves a look at a particular institution that may manage the assets of hundreds of plans. So one investigation may give us some insight into how 100 or 1,000 plans are being managed.

Mr. ANTHONY. I was curious about the fact you had set up a model, using fiduciaries for a multitude of plans and service organizations—do you pick those because you suspect that is where the abuse is, or do you pick those because that is where the numbers are?

Mr. LEBOWITZ. I think it is a combination of the two. The sources of information that we have include the information that we get off the 5500 form, participant complaints, press reports and other sources of information that may lead us to believe a particular service provider or a particular financial institution or organization deserves some further inquiry by us; and others are chosen on the basis of their impact on a particular market or the numbers of plans that they manage.

Mr. ANTHONY. As a result of that targeting, have you had the same type of results that you had when you went after the Central States where you recovered the $21 million?

Mr. LEBOWITZ. Well, I think——

Mr. ANTHONY. Have you been that successful for other plan beneficiaries?

Mr. LEBOWITZ. I think—well, it is hard to compare the results that we have had with the Central States over the years with other kinds of investigations that we have undertaken. I think it is fair to say that was a fairly unique situation.

Mr. ANTHONY. I am trying to ascertain whether you have identified a segment group within that large group that you have targeted that you think need a more watchful eye than others?

Mr. LEBOWITZ. I don't think that I would say that there is any particular category of plans or particular kind of——

Mr. ANTHONY. I am speaking of individuals or organizations. Do you find some cut the edge closer than others? That is what I am asking.

Mr. LEBOWITZ. There are individuals whose names appear frequently in our investigations, and obviously to the extent that we can identify those individuals as being affiliated or involved with other plans, we are going to——

Mr. ANTHONY. You will be taking a look after them?

Mr. LEBOWITZ. Yes, sir.

Mr. ANTHONY. In 1986–87, the trend lines seem to be fairly flat. What about the first half of 1988, will the year-end number be consistent with 1986–87 there?

Mr. LEBOWITZ. The number for the first half of 1988 was 741 investigations closed, which is slightly below the actual numbers of prior years. It is difficult to know at any point in time what the whole year is going to look like.

I should point out that this fiscal year is the first complete fiscal year we have implemented this new emphasis on service providers and financial institutions, so we have been reorienting our field staff and providing more intensive training. That may be partially why the numbers are slightly below what they were.

But our results are still quite good. We have restored assets in the first half of this fiscal year in the amount of $58 million.

Mr. ANTHONY. How do you actually go about restoring those benefits?

Mr. LEBOWITZ. These are dollars actually returned to the plan that would otherwise not have been there.

Mr. ANTHONY. Who returns the money?

Mr. LEBOWITZ. The fiduciaries who are liable under ERISA. To make restitution to the plan and to disgorge profits that they had made unlawfully in connection with a breach of fiduciary responsibility.

Mr. ANTHONY. Would this be as a result of lawsuits and/or negotiated-out settlements?

Mr. LEBOWITZ. Both.

Mr. ANTHONY. I guess what caught my attention about Mr. Posner's testimony, and then your testimony, was the fact that if we just stopped with your testimony, it appears that I could walk out of this hearing and go back into my district and say "We have got a terrible problem here because you have uncovered a 100-percent increase in illegal activity."

You mentioned in 1986, you recovered $72 million on $3.6 million excise tax, in 1987 it went to—I thought you said $140 million.

Mr. POSNER. Yes. The figure that I——

Mr. ANTHONY. Is that an unfair characterization?

Mr. POSNER. Well, the——

Mr. ANTHONY. That the discovered and punished illegal activity doubled in that period of time?

Mr. POSNER. Well, in 1987, just to recap the figures, we levied $6.9 million in excise tax, and that involved $140 million of prohibited transactions.

Mr. ANTHONY. And $72 the year before?

Mr. POSNER. In 1987. In 1986, the figure was $3.6 million on $72 million. That increase was largely the result of some very large prohibited transactions. For fiscal year 1988 so far, we have recovered $1.5 million—I should say we have imposed an excise tax of $1.5 million on prohibited transactions equal to about $30 million,

and that would be an annual rate of about $3 million of excise taxes on an amount involved of $60 million, and that compares with the 1986 figure.

Mr. ANTHONY. What was this unusual blip? I guess I didn't read it in the paper.

Mr. POSNER. They just happened to be some large amounts.

Mr. ANTHONY. How did you go about catching them versus that not showing up the year before or the year after?

Mr. POSNER. I really do not have the details on that except that I asked the same question myself, and I was told that just resulted from some fairly high amounts of prohibited transactions.

Mr. ANTHONY. I am going to have a hard time being satisfied with that answer. I wish you would go back to your shop and ask for more clarification, because again at first blush it seems—on the one hand, there is increased illegal activity, and then, on the other hand, I could say you have just gotten real lax in 1988.

I would like to see what the facts are. So if you could get back with them and find out a little more about what the details are and what that particular situation involved, I would like for the committee to be a little more educated on it.

Mr. POSNER. I would be happy to.

[The following was subsequently received:]

EXCISE TAXES

In Fiscal year 1986 we levied $3.6 million in excise taxes for prohibited transaction violations. In Fiscal Year 1987 the figure was $6.9 million. The main reason for the difference was one case involving an assessment of over $4 million on a husband and wife. This case, *Zabolotny and Zabolotny v. Commissioner*, is now in U.S. Tax Court, Docket No. 4844-87.

Mr. ANTHONY. Otherwise we are going to end up with a distorted viewpoint here, and that is certainly not what we are after. We are trying to find out if there is a real problem.

Mr. POSNER. In looking at the statistics for prior years, fiscal year 1987 does seem to be an aberration in that it did result in higher excise taxes than in most other years.

Mr. ANTHONY. I wish you would take a look at it. I have got just one basic question. After hearing all of your testimony and hearing about your stepped-up compliance efforts, and that is just a basic simple question of when would you rev up? I know when you can rev up. I am curious when you will rev up. You stated it is the world's worst possibility because you disqualified the plan, and that is the worst of all scenarios, and it is tough, and it is something you don't particularly want to do, and you would much rather have other alternatives.

But inasmuch as it is part of the penalty process, my question is: What kind of case would it take before you would disqualify the plan?

Mr. POSNER. For violations of the exclusive benefit rule by its very nature, the violation has to be pervasive, that is all-encompassing, so that we feel the plan is not serving the purpose for which it was established, that being for the exclusive benefit of employees and beneficiaries.

Mr. ANTHONY. What about the person taking antiques home, did he get disqualified?

Mr. POSNER. Yes, sir.

Mr. ANTHONY. Good. Thank you. That was also a small case. You have really been talking about the big plans and not so much about the little plan.

How do you go about overseeing and making sure the little plans don't slip through the cracks? I know the big dollars are in the big plans and the big plans have the complicity of fiduciaries and service people. But with a million numbers out there, large and small numbers will end up in lots of big bucks.

How do you keep it from falling through the cracks? And how did you find this one?

Mr. POSNER. Well, this plan was an examination case, and that means more than likely it was picked up by our DIF ratings. It was rated as a plan, not only for the investments, but it was rated based on the filing of the 5500, and it was profiled as a high-risk plan, and that is the way most of our examinations begin, from the profile.

Mr. ANTHONY. Well, I am going to ask both of you a final question. With your stepped-up efforts, and I applaud you both for those, knowing what the current legal situation is, do you have all of the tools that you need or do you think there is additional tools that both of you could use, IRS and labor?

Take IRS first. Are there additional legislative regulatory tools you could use?

Mr. POSNER. Well, Mr. Anthony, I have testified that we would like additional flexibility so that we can impose sanctions that are short of disqualification. The Commissioner has underway right now a penalty study, which covers penalties in all income tax areas but also includes those in the employee plan areas, and I am sure there will be a number of recommendations coming out of that study.

Mr. LEBOWITZ. Mr. Anthony, I think that it is fair to say title I of the ERISA contains a wide variety of sanctions that we can bring to bear in situations where we believe it is appropriate. Combining that with the excise taxes that can be imposed under the Internal Revenue Code and civil penalties under ERISA for nonpension plans, I don't think that there is any problem at this point in terms of enforcement tools we have available.

Mr. ANTHONY. I said that the previous question was going to be my last, however, it was my next to the last question. My last question would be this. As to coordination between the two of you, you talked about the multitude of regulatory agencies you are coordinating with. Do you feel like for the moment you have all of the tools that you need for those agencies to totally cooperate, and act in concert, or do you see some problems there?

I guess I would be more interested if you see any more problems you could bring to our attention that need to be smoothed out or addressed.

Mr. POSNER. I don't see any problems. We and the Department of Labor coordinate quite closely. We have regular and continuing meetings to assure that our examinations are coordinated and that there isn't duplication of efforts and resources.

As I have said, we are really in a transitional period going to an emphasis on examinations. I think that as time goes on, we shall

see the results of that program and what additional emphasis or rules will be needed as a result of the information turned up by those examinations.

Mr. ANTHONY. I think that is excellent, and I thank both of you for your testimony. Let me encourage you to keep going, because nobody believes what Mr. Lebowitz said that is a potential beneficiary of a pension plan thinks that their benefits went down substantially and have not been recovered.

As a result of some of the publicity about some of the plans being stolen from and abused, I can tell you there is also a lot of concern among the beneficiaries to make sure when they do put in years and years of work, benefits will be there.

So we are certainly not there in terms of having satisfied these beneficiaries. I want to encourage both of you to keep up the good work. I appreciate your presentations today.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman. I have no questions.

Mr. ANTHONY. Thank you. You may be excused.

[Subsequently, the following questions and answers were submitted for the record:]

J.J. PICKLE, TEXAS, CHAIRMAN
SUBCOMMITTEE ON OVERSIGHT

BERYL ANTHONY, JR., ARKANSAS
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Ex Officio:
DAN ROSTENKOWSKI, ILLINOIS
BILL ARCHER, TEXAS

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, DC 20515

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A.L. SINGLETON, MINORITY CHIEF OF STAFF
MICHAEL A. SUPERATA, COUNSEL TO THE MINORITY

August 31, 1988

Mr. William Posner
Assistant Director
Employee Plans Technical
and Actuarial Division
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D. C. 20224

Dear Mr. Posner:

I want to thank you for your testimony at the Subcommittee on Oversight's hearing on the investment of pension plan assets. To complete our hearing record, I would appreciate having your responses to the attached questions by the close of business Friday, September 30, 1988.

Your attention to this matter is greatly appreciated. If any assistance is needed, please contact Rusty Guritz, Counsel, or Tom Arnold, Investigator, at 225-5522.

Sincerely,

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/tal
Enclosure

[THE ENCLOSURE TO THIS LETTER WAS NOT REPRINTED SINCE THE INTERNAL REVENUE SERVICE REPEATED THE QUESTIONS IN THEIR RESPONSE.]

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10-25-88

PW, TM, HO, SO

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

ASSISTANT COMMISSIONER
(EMPLOYEE PLANS AND
EXEMPT ORGANIZATIONS)

RECEIVED
OCT 25 1988
Ways and Means
Subcommittee on Oversight

OCT 21 1988

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
U. S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

This is in response to your request for the responses of Mr. William Posner of my staff with regard to a series of questions resulting from your Subcommittee's hearing on the investment of plan assets. The responses to your questions are enclosed.

My staff and I would be happy to provide any further information that you may require.

Sincerely,

Robert I. Brauer

Enclosures

[THE APPENDIX TO THIS LETTER IS BEING RETAINED IN THE COMMITTEE FILES.]

RESPONSES TO SUBCOMMITTEE ON OVERSIGHT QUESTIONS REGARDING INVESTMENT OF PLAN ASSETS

Q1. What are the qualification requirements regarding investments of plan assets? In other words, what must a pension plan contain regarding investment policies in order for IRS to issue a favorable determination letter that it is a qualified plan?

A1. In order for a plan to be qualified, the plan must provide pursuant to section 401(a)(2) of the Internal Revenue Code of 1986 that the plan assets cannot be "used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries . . . ." A plan that includes the above language need not include any other language with respect to plan investments in order to be qualified. If a plan does include other language such language cannot be inconsistent with the "exclusive benefit" rule. See, for example, Rev. Rul. 73-532, 1973-2 C.B. 128, which held that a plan that authorized the trustees to invest "without regard to whether investments may be new, speculative, hazardous, adventurous, or productive of income" did not satisfy the exclusive benefit requirements of section 401(a) and therefore was not qualified.

Q2. Under what circumstances can IRS revoke a plan's qualification on account of investment policies?

A2. The IRS will revoke a plan's qualification on account of investment policies if the plan is not investing for the exclusive benefit of employees and their beneficiaries. However, the IRS generally will not revoke for prohibited transactions. Prohibited transactions generally result in excise taxes rather than disqualification; but in some cases, as the examples in the testimony indicate, if prohibited transactions are imprudent and so pervasive as to taint the whole plan, they will be treated as exclusive benefit violations as well as prohibited transactions, resulting in plan disqualification.

Q3. How many plans were revoked last year on account of investment practices?

A3. About 100 plans a year have their qualification revoked. Of these 100, generally between 5 and 10 are disqualified primarily for exclusive benefit violations.

Q4. What prohibited transaction excise taxes were imposed last year? How many plans were involved? How many of these also resulted in revocation? Please answer these same questions for FY 1988 year-to-date.

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A4. Our reports indicate that for FY 1987, $6,943,543 in excise taxes for prohibited transactions (over $4 million of which were from one plan) were assessed, involving 2444 returns. For FY 1988-to-date (June 30, 1988, quarterly report) $1,955,135 in excise taxes for prohibited tranactions were assessed, invclving 870 returns. The lower numbers in FY 1988 reflect the low overall number of examinations conducted in FY 1987 as compared to FY 1986 (assessments in year two generally reflect examinations in year one) because of emphasis in FY 1987 on the determination letter program. Our reemphasis of examinations should increase the numbers for the future. Our reporting system is based on returns, not plans. If a prohibited transaction is for more than one year, it will involve several returns. Thus, the number of plans involved is less than the number of returns; however, our reporting system does not provide us with data on the number of plans. At this time, our data base also does not distinguish whether a plan involved in a prohibited transaction also had its qualification revoked by the Service; however, based on our experience we expect that only a few of the plans involved with prohibited transactions also had exclusive benefit violations or other violations that would result in disqualification.

Q5. How many referrals are made to the Department of Labor annually?

A5. In the first three quarters of FY 1988, 620 referrals (320 in the third quarter) were made to Labor. We expect that the number will increase to our previous average of 1000 to 1100 a year as we reemphasize examinations.

Q6. From your viewpoint as tax administrator, are the current rules adequate to ensure that pension funds are being invested responsibly and in the best interests of the plan participants and their beneficiaries?

A6. We believe the current tax rules provide us with sufficient authority to carry out our role in protecting participants and beneficiaries, especially since the exclusive benefit and prohibited transaction rules of the Code are supplemented by the rules of Title I of ERISA which are administered by the Department of Labor.

Q7. When was the last TCMP (Taxpayer Compliance Measurement Program) conducted to determine the level of compliance with ERISA? When is the next one scheduled?

A7. The last TCMP was conducted on employee plan returns filed for 1978. It is expected that a TCMP will be conducted on employee plans returns filed for 1990, after the Tax Reform Act of 1986 changes are incorporated into the returns.

Q8. What are your current staffing levels? Have they increased in the last 2 years?

A8. Our FY 1989 budget for Employee Plans provides 1970 staff years. This is an increase over the 1943 staff years level authorized for FY 1988. In FY 1987 the authorized level was 1702 staff years (after a supplemental appropriation). These increases are to cover additional work arising from the Tax Reform Act of 1986.

Q9. What record-keeping requirements are imposed on plans? Who has access to those records? How does one gain access to those records?

A9. Section 6058 of the Code and section 301.6058-1 of the regulations requires an annual report to be filed with the Service. Section 301.6058-1(c)(4) requires that records substantiating all data and information required for the annual report be kept available for inspection by the IRS. Participants do not have access to these records under the Code. Under Title I of ERISA, which is administered by the Department of Labor, participants do have access to certain records.

Q10. Are plans required to publish any information about the plan? About investments? Please explain.

A10. There are no requirements under the qualification provisions that the plan publish any information about the plan or the plan's investments. Certain plan investment information, however, is required as part of the annual report. Failure to provide this information on the annual report subjects the responsible party to penalties under the Code.

Q11. What statistics does the IRS have on where pension plans are investing their money? What information regarding investments must pension plans report to the IRS and when?

A11. The IRS does not compile statistics on where pension plans are investing their money. Pension plans are required to report annually certain investment information on the Form 5500. This information, however, is not compiled by the IRS for any statistical purposes.

Q12. The Form 5500 requires that plans report the amount invested in stock. Can a plan participant find out from either the IRS or from the plan what specific stock is owned by the plan at any given time? If so, how would a plan participant go about doing that?

A12. Title I of ERISA, which is administered by the Department of Labor, sets forth specific requirements with

respect to what must be disclosed by the plan sponsor to the plan's participants and beneficiaries. While the Code requires preparation of the annual report and keeping of certain records for tax purposes, the Code has no requirements with respect to disclosure of investment information to participants.

Q13. Please furnish several copies of completed Form 5500's from several different type and size plans.

A13. The Department of Labor maintains a public disclosure room where individuals may obtain copies of the Form 5500, Form 5500-C, Form-R and the accompanying schedules. They have provided us with the attached Forms as samples. We have included a variety of forms as you requested.

Q14. Please describe several actual cases discovered by the IRS involving violations of the exclusive benefit and/or other fiduciary rules.

A14. Generally, if a prohibited transaction is so pervasive as to affect the whole plan, a plan would be disqualified for an exclusive benefit violation. One case involved the plan of a professional corporation. The plan fiduciary, who was the sole shareholder of the professional corporation, invested 94% of the plan's assets in rugs, antiques and other collectibles. He then "stored" the collectibles in his home. In another professional corporation case, the sole shareholder, who was the plan fiduciary, had the plan make a loan to him involving 90% of the plan's assets without adequate security. In addition, the loan resulted in the plan having insufficient assets to pay out benefits to other participants when they became due. In a non-professional corporation case, three brothers owned a company. They had the pension plan make a loan of 90% of the plan assets to the company at 10% when the prime rate was 21.5%.

Q15. How many investment transactions are conducted in one year by an "average" plan? What factors contribute to that activity?

A15. IRS does not maintain statistics that would identify the average number of investments by a plan in a single year. In any case, such an average could be misleading. For example, some small plans may have several hundred stock transactions, even though each investment is only a small amount. While some large plans could have only a few transactions, but the investments could be in the millions. Also, many plans, especially large ones, have a number of investment advisors handling a portion or all of their assets. This could result in thousands of investments or only a few.

Q16. Please furnish copies of Reorganization Plan Number 4 and the implementing IRS/DOL agreement.

A16. See attached.

tion was not published prior to its effective date because the percentage is computed on the basis of data which was not then available.

DONALD C. LUBICK,
Assistant Secretary.

(Filed by the Office of the Federal Register on March 20, 1979, 8:45 a.m., and published in the issue of the Federal Register for March 21, 1979, 44 F.R. 17158)

Reorganization Plan No. 4 of 1978

Prepared by the President and transmitted to the Senate and the House of Representatives in Congress assembled, August 10, 1978, pursuant to the provisions of Chapter 9 of Title 5 of the United States Code.[1]

Employee Retirement Income Security Act Transfers

SECTION 101. *Transfer to the Secretary of the Treasury.*

Except as otherwise provided in Sections 104 and 106 of this Plan, all authority of the Secretary of Labor to issue the following described documents pursuant to the statutes hereinafter specified is hereby transferred to the Secretary of the Treasury:

(a) regulations, rulings, opinions, variances and waivers under Parts 2 and 3 of Subtitle B of Title I and subsection 1012(c) of Title II of the Employee Retirement Income Security Act of 1974 [1974-3 C.B. 1] (29 U.S.C. 1001 note) (hereinafter referred to as "ERISA"),

EXCEPT for sections and subsections 201, 203(a)(3)(B), 209, and 301(a) of ERISA;

(b) such regulations, rulings, and opinions which are granted to the Secretary of Labor under Sections 404, 410, 411, 412, and 413 of the Internal Revenue Code of 1954, as amended, thereinafter referred to as the "Code").

EXCEPT for subsection 411(a)(3)(B) of the Code and the definitions of "collectively bargained plan" and "collective bargaining agreement" contained in subsections 404(a)(1)(B) and (a)(1)(C), 410(b)(2)(A) and (b)(2)(B), and 413(a)(1) of the Code; and

(c) regulations, rulings, and opinions under subsections 3(19), 3(22), 3(23), 3(24), 3(25), 3(27), 3(28), 3(29), 3(30), and 3(31) of Subtitle A of Title I of ERISA

SECTION 102. *Transfers to the Secretary of Labor.*

Except as otherwise provided in Section 105 of this Plan, all authority of the Secretary of the Treasury to issue the following described documents pursuant to the statutes hereinafter specified is hereby transferred to the Secretary of Labor:

(a) regulations, rulings, opinions, and exemptions under section 4975 of the Code,

EXCEPT for (i) subsections 4975(a), (b), (c)(3), (d)(3), (e)(1), and (e)(7) of the Code; (ii) to the extent necessary for the continued enforcement of subsections 4975(a) and (b) by the Secretary of the Treasury, subsections 4975(f)(1), (f)(2), (f)(4), (f)(5) and (f)(6) of the Code; and (iii) exemptions with respect to transactions that are exempted by subsection 404(c) of ERISA from the provisions of Part 4 of Subtitle B of Title I of ERISA; and

(b) regulations, rulings, and opinions under subsection 2003(c) of ERISA.

EXCEPT for subsection 2003(c)(1)(B).

SECTION 103. *Coordination Concerning Certain Fiduciary Actions.*

In the case of fiduciary actions which are subject to Part 4 of Subtitle B of Title I of ERISA, the Secretary of the Treasury shall notify the Secretary of Labor prior to the time of commencing any proceeding to determine whether the action violates the exclusive benefit rule of subsection 401(a) of the Code, but not later than prior to issuing a preliminary notice of intent to disqualify under that rule, and the Secretary of the Treasury shall not issue a determination that a plan or trust does not satisfy the requirements of subsection 401(a) by reason of the exclusive benefit rule of subsection 401(a), unless within 90 days after the date on which the Secretary of the Treasury notifies the Secretary of Labor of pending action, the Secretary of Labor certifies that he has no objection to the disqualification or the Secretary of Labor fails to respond to the Secretary of the Treasury. The requirements of this paragraph do not apply in the case of any termination or jeopardy assessment under sections 6851 or 6861 of the Code that has been approved in advance by the Commissioner of Internal Revenue, or, as delegated, the Assistant Commissioner for Employee Plans and Exempt Organizations.

SECTION 104. *Enforcement by the Secretary of Labor.*

The transfers provided for in Section 101 of this Plan shall not affect the ability of the Secretary of Labor, subject to the provisions of Title III of ERISA relating to jurisdiction, administration, and enforcement, to engage in enforcement under Section 502 of ERISA or to exercise the authority set forth under Title III of ERISA, including the ability to make interpretations necessary to engage in such enforcement or to exercise such authority. However, in bringing such actions and in exercising such authority with respect to Parts 2 and 3 of Subtitle B of Title I of ERISA and any definitions for which the authority of the Secretary of labor is transferred to the Secretary of the Treasury as provided in Section 101 of this Plan, the Secretary of Labor shall be bound by the regulations, rulings, opinions, variances, and waivers issued by the Secretary of the Treasury.

SECTION 105. *Enforcement by the Secretary of the Treasury.*

The transfers provided for in Section 102 of this Plan shall not affect the ability of the Secretary of the Treasury, subject to the provisions of Title III of ERISA relating to juris-

[1] As amended September 20, 1978.

diction, administration, and enforcement, (a) to audit plans and employers and to enforce the excise tax provisions of subsections 4975(a) and 4975(b) of the Code, to exercise the authority set forth in subsections 502 (b)(1) and 502(h) of ESISA, or to exercise the authority set forth in Title III of ERISA, including the ability to make interpretations necessary to audit, to enforce such taxes, and to exercise such authority; and (b) consistent with the coordination requirements under Section 103 of this Plan, to disqualify, under section 401 of the Code, a plan subject to Part 4 of Subtitle B of Title I of ERISA, including the ability to make the interpretations necessary to make such disqualification. However, in enforcing such excise taxes and, to the extent applicable, in disqualifying such plans the Secretary of the Treasury shall be bound by the regulations, rulings, opinions, and exemptions issued by the Secretary of Labor pursuant to the authority transferred to the Secretary of Labor as provided in Section 102 of this Plan.

SECTION 106. *Coordination for Section 101 Transfers.*

(a) The Secretary of the Treasury shall not exercise the functions transferred pursuant to Section 101 of this Plan to issue in proposed or final form any of the documents described in subsection (b) of this Section in any case in which such documents would significantly impact on or substantially affect collectively bargained plans unless, within 100 calendar days after the Secretary of the Treasury notifies the Secretary of Labor of such proposed action, the Secretary of Labor certifies that he has no objection or he fails to respond to the Secretary of the Treasury. The fact of such a notification, except for such notification for documents described in subsection (b)(iv) of this Section, from the Secretary of the Treasury to the Secretary of Labor shall be announced by the Secretary of Labor to the public within ten days following the date of receipt of the notification by the Secretary of Labor.

(b) The documents to which this Section applies are:

(i) amendments to regulations issued pursuant to subsections 202 (a)(3); 203(b)(2) and (3)(A), 204 (b)(3)(A), (C), and (E), and 210 (a)(2) of ERISA, and subsections 410 (a)(3) and 411(a)(5), (6)(A), and (b)(3)(A), (C), and (E), 413(b)(4) and (c)(3) and 414(f) of the Code;

(ii) regulations issued pursuant to subsections 204(b)(3)(D), 302 (c)(8), and 304(a) and (b)(2)(A) of ERISA, and subsections 411 (b)(3)(D), 412(c)(8), (e), and (f)(2)(A) of the Code; and

(iii) revenue rulings (within the meaning of 26 CFR Section 601.201 (a)(6)), revenue procedures, and similar publications, if the rulings, procedures and publications are issued under one of the statutory provisions listed in (i) and (ii) of this subsection; and

(iv) rulings (within the meaning of 26 CFR Section 601.201(a)(2)) issued prior to the issuance of a published regulation under one of the statutory provisions listed in (i) and (ii) of this subsection and not issued under a published Revenue Ruling.

(c) For those documents described in subsections (b)(i), (b)(ii) and (b)(iii) of this Section, the Secretary of Labor may request the Secretary of the Treasury to initiate the actions described in this Section 106 of this Plan.

SECTION 107. *Evaluation.*

On or before January 31, 1980, the President will submit to both Houses of the Congress an evaluation of the extent to which this Reorganization Plan has alleviated the problems associated with the present administrative structure under ERISA, accompanied by specific legislative recommendations for a long-term administrative structure under ERISA.

SECTION 108. *Incidental Transfers.*

So much of the personnel, property, records, and unexpended balances of appropriations, allocations and other funds employed, used, held, available, or to be made available in connection with the functions transferred under this Plan, as the Director of the Office of Management and Budget shall determine, shall be transferred to the appropriate agency, or component at such time or times as the Director of the Office of Management and Budget shall provide, except that no such unexpended balances transferred shall be used for purposes other than those for which the appropriation was originally made. The Director of the Office of Management and Budget shall provide for terminating the affairs of any agencies abolished herein and for such further measures and dispositions as such Director deems necessary to effectuate the purposes of this Reorganization Plan.

SECTION 109. *Effective Date.*

The provisions of this Reorganization Plan shall become effective at such time or times, on or before April 30, 1979, as the President shall specify, but not sooner than the earliest time allowable under Section 906 of Title 5, United States Code.

(Filed by the Office of the Federal Register on October 16, 1978, 12:05 p.m., and published in the issue of the Federal Register for October 17, 1978, 43 F.R. 47713)

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, Section 7701; 301.7701-4.)

Rev. Proc. 79-1

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to specify the conditions that must be present before the Internal Revenue Service will consider issuing advance rulings concerning the classification of organizations as liquidating trusts under section 301.7701-4 of the Procedure and Administration Regulations.

SEC. 2. BACKGROUND.

The operating rules published in this Revenue Procedure are intended solely to assist taxpayers and their representatives in preparing ruling requests. These operating rules do not

MODIFICATION OF THE
PROCEDURES BETWEEN THE INTERNAL REVENUE SERVICE
AND THE DEPARTMENT OF LABOR FOR THE COORDINATION
OF EXAMINATION AND LITIGATION ACTIVITIES
INVOLVING EMPLOYEE BENEFIT PLANS

Whereas Part IV of The Agreement Between The Internal Revenue Service And The Department Of Labor For The Coordination Of Examination And Litigation Activities Involving Employee Benefit Plans executed April 18, 1983, provides for modification of coordination procedures, and based upon a review of The Procedures by personnel of the Internal Revenue Service and personnel of the Pension and Welfare Benefits Administration (PWBA) of the Department of Labor, The Procedures (attached) have been modified to be effective as of September 1, 1987.

Signed at Washington, D.C. this 21st, 1987

Robert I. Brauer
Assistant Commissioner
(Employee Plans and
Exempt Organizations)
Internal Revenue Service

Alan D. Lebowitz
Director of Program Operations
Pension and Welfare Benefits
Administration
Department of Labor

MEMORANDUM OF UNDERSTANDING

Internal Revenue Service/Department of Labor Coordination Agreement

In order for the IRS and DOL to fulfill the mandate of Congress as presented in 29 USC 1136, the Employee Retirement Income Security Act of 1974 (ERISA), the IRS and DOL have executed the Internal Revenue Service/Department of Labor Coordination Agreement (Agreement).

The attached Agreement is the third in nine years and the revisions are the culmination of the Agencies' experiences under the prior Agreements.

During the past year both agencies have improved their record keeping on the items referred and their follow-up on non-response by the other agency. An essential component of the Agreement is timely coordination and emphasis on the need to eliminate duplicate investigative efforts.

DOL will continue to refer Checksheet A to IRS in accordance with the requirements of Article II, C.5, of the

Agreement. Excise tax on a prohibited transaction will be imposed by IRS based on a recommendation by DOL.

IRS will not conduct a separate examination regarding the prohibited transaction. If the DOL referral does not contain sufficient documentation for IRS to impose the excise tax, the referral will be returned to DOL for submission of material which will substantiate imposition of the excise tax. In the event no excise tax is imposed by IRS regarding a prohibited transaction referred by DOL with sufficient documentation, IRS will annotate the case file and provide DOL with an explanation of why the excise tax was not imposed. The explanation will be provided in Part II of Checksheet A returned to DOL. IRS will notify DOL of, and will hold discussions with DOL prior to, any proposed change in the dollar amount in the IRS Law Enforcement Manuals concerning imposition of the excise tax on a prohibited transaction recommended by DOL.

In accordance with Article V.C of the Agreement, the Chief EP/EO Examination Branch, Operations Division, IRS, and Chief, Division of Field Operations, Office of Enforcement, DOL, will meet quarterly to resolve problems encountered by PWBA Area Offices and IRS Key District Offices in following the provisions of the Agreement.

Also, in view of the significant efforts required of both agencies under the Agreement, the Director, Employee Plans & Exempt Organizations, IRS, and the Associate Director for Enforcement, PWBA, will meet within 12 months from the effective date of the Agreement, to review the activities of each agency under the Agreement, particularly with regard to the provisions of Article II, C.5 and C.7.

Robert E. Withers
Director
Employee Plans & Exempt
Organizations
Internal Revenue Service

Charles Lerner by POP

Charles Lerner
Associate Director
for Enforcement
Pension and Welfare Benefits
Administration

IRS/DOL Coordination Agreement

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B. Referral Checksheets A, B & C
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E. Letter Informing Department of Labor of Employee Plans and Exempt Organizations Cases in Appeals
F. Geographic Listing of PWBA Area Offices

This document provides procedures for the coordination of examination and litigation activities involving employee benefit plans between the Pension and Welfare Benefits Administration (PWBA) of the Department of Labor (DOL) and the Internal Revenue Service (IRS) ("The Procedures").

I. Notification of Examinations

A. General

For the agencies to avoid unnecessary duplication in examinations each PWBA Area Office will notify IRS of the names of plans selected for civil investigation by the Area Office. To notify IRS, the Area Office will transmit a PWBA Form 205, using Document Transmittal Form 217 (See Appendix C), with respect to each such plan to the Chief, Employee Plans/Exempt Organizations Division (or designee) of the IRS Key District Office with jurisdiction over the plan not later than the last workday of each week. The Area Office will not begin its investigation of a plan until 20 workdays after the date of the Form 217 which transmits PWBA Form 205 notifying IRS of the investigation. If during that period IRS advises the Area Director/District Supervisor that the investigation would duplicate an examination by IRS, the procedures in section C of this Part will apply.

B. IRS Action on Notification

Within 19 workdays after the date of a Form 217 which transmits PWBA Form 205 giving notification of an investigation by DOL, the IRS EP/EO Division receiving the form will determine whether the investigation would duplicate an examination by IRS and, if the investigation is duplicative, advise, the Area Director/District Supervisor by telephone and confirm the response in writing within five workdays.

1. For purposes of notifying PWBA of examinations in process by IRS, a plan will be considered under examination if: (1) an examination was closed by IRS with respect to the plan within 12 months of the date of the PWBA Form 205; (2) an examination case with respect to the plan is in inventory in the EP/EO Division but not yet assigned; or (3) an examination with respect to the plan is currently assigned within the EP/EO Division.

2. If a plan listed on a PWBA Form 205 is a welfare benefit plan, the EP/EO Division will request a transcript from the Exempt Organizations Business Master File (EOBMF).

3. If a plan listed on a PWBA Form 205 is an employee benefit plan, the EP/EO Division will determine whether the plan is under examination by requesting an IDRS search with respect to the plan. If no record of the plan is found on IDRS, the Division will initiate a Form 3774 (Microfilm Research Request) concerning the plan.

4. If the EP/EO Division determines that a plan listed on a PWBA Form 205 is not under examination, the Division will take action to associate the form with the IRS administrative file relating to the plan. If the EP/EO Division subsequently assigns such a plan for examination, the Division will, prior to examining the plan, contact the PWBA Area Office concerning the results of DOL's investigation.

C. PWBA Action After Positive Feedback

Generally, a PWBA Area Office will not begin an investigation of a plan if IRS advises the Area Director/District Supervisor that the investigation would be duplicative. If IRS has selected a plan for examination but has not yet initiated contact with the plan, the PWBA Area Office and EP/EO Division

with jurisdiction over the plan will decide which agency will examine/investigate the plan. Any jurisdictional disputes will be resolved in accordance with section A.3.(h) of Part II below.

II. Examination Referral Program

A. General

1. The agencies have developed checksheets for determining whether issues presented in an examination/investigation by one agency should be referred to the other agency. The checksheets are three-part snapout forms (respectively known as Checksheets A, B, and C or Forms 6212A, B, and C) and are included in Appendix B. When either agency completes a checksheet during an examination/investigation, an entry in the righthand column with respect to any item on the checksheet will indicate that referral of the checksheet to the other agency is required. The completed checksheets contain confidential tax return information provided by the IRS and must be safeguarded by PBWA officers and employees.

2. For purposes of the Examination Referral Program (Part II) and IRS Appeals Office Procedures (Part III), the term "examination" means:

(a) In the case of an examination of an employee benefit plan conducted by IRS, (1) any field examination by EP specialists of the books and records of an employee benefit plan and (2) any field examination by EO specialists of the books and records of an employee welfare benefit plan which is intended to be exempt under section 501(c) of the Internal Revenue Code (including section 501(c)(9), (c)(17), and (c)(20)) or which is intended to qualify under section 120 of the Code. An examination described in this paragraph will be subject to the referral procedures without regard to whether the examination is an on-site examination or an office correspondence/interview examination.

(b) In the case of an investigation of an employee benefit plan conducted by the PWBA, any investigation or audit of the books and records of an employee benefit plan; and

(c) In the case of an examination/investigation of an entity other than a plan by either agency, any examination/investigation the purpose of which is to determine compliance with the Employee Retirement Income Security Act of 1974 (ERISA), related sections of the Internal Revenue Code, or both.

3. Referral Procedures

(a) PWBA investigators/auditors will complete Checksheets A and C during their investigations. Checksheets referred to IRS will be sent to the Chief, EP/EO Division (or designee), of the IRS Key District Office with jurisdiction over the plan using Document Transmittal Form 217 (see Appendix C) on the last workday of each week.

(b) IRS examiners will complete Checksheet B during their examinations. Checksheets referred to PWBA will be sent (along with copies of 5500 Series returns relating to the plans subject to the referral) to the Area Director/District Supervisor whose office has jurisdiction over the plans on the last workday of each week.

(c) The initiating agency will complete all three parts of a checksheet during an examination/investigation. If referral is required, the agency initiating the checksheet will file Part Three in a separate control file (maintained in the EP/EO Division of each IRS Key District Office and in each PWBA Area Office). The agency making the referral will transmit Parts One and Two to the other agency, which will complete the "Action Taken" portion of the referral checksheet. The agency receiving the Form will retain Part One in a separate file and will return Part Two to the initiating agency to be included in the appropriate plan administrative/case file.

(d) After receiving a referral, an agency may request additional information from the initiating agency with respect to the plan involved. Such a request should be made within 15 workdays of the date the referral was mailed. The request should not require the initiating agency to conduct an additional investigation or examination. A request for additional information by DOL must comply with the requirements of Section 6103(1)(2) of the Code.

(e) An agency initiating a referral will generally not take dispositive action on the examination until the earlier of (1) receipt of a response from the other agency that it will not participate in the examination, or (2) 20 workdays after the date of the document transmitting the referral. An agency initiating a referral may request that the receiving agency coordinate in the examination. Such a request will be made by checking the "Participation Requested" box on the referral checksheet and obtaining the signature of the Area Director/District Supervisor or Chief, EP/EO Division. When the coordination of the other agency is requested, the agency initiating the referral will generally not take dispositive action on the examination until the receipt of the response from the other agency that it will not coordinate in the examination. However, an agency may take dispositive action if collection of a tax is in jeopardy, the running of the statute of limitations is imminent, or plan assets or the interests of plan participants must be protected. In such a case, the agency taking the dispositive action will immediately notify the other agency of the action by telephone and confirm the notification in writing within five workdays.

(f) Except as stated in (e) above, an agency initiating a referral is generally not required to postpone taking dispositive action on an examination.

(g) If the agency receiving a referral checksheet indicates an interest in the case, the agencies will coordinate in accordance with the procedures described in sections B. and C. of this Part.

(h) Disagreement concerning appropriate enforcement action in a specific case will generally be resolved by the IRS Key District Office and the PWBA Area Office with jurisdiction over the plan involved. If a Key District Office and an Area Office are unable to reach agreement in a case, they will forward the case to their respective National Offices for final resolution.

(i) Area Directors of PWBA and Chiefs, EP/EO Division of IRS may jointly develop procedures for PWBA field offices to discuss corrective action regarding a prohibited transaction with the Chief, EP/EO Technical/ Review Staff (or designee) of the IRS Key District Office with jursidiction over the plan involved. Such discussions may be held prior to the receipt of a referral from PWBA regarding the prohibited transaction.

B. Examinations Initiated by IRS

1. IRS examiners will complete Checksheet B as soon as possible in all IRS field examinations.

2. When an entry on a Checksheet B requires the referral of the checksheet to PWBA, IRS will refer the checksheet in accordance with section A.3.b of this Part.

3. PWBA will review Checksheet B, complete the "Action Taken" portion of the referral checksheet, and return Part Two to IRS within 20 workdays of the date of the memorandum or other document transmitting the checksheet to PWBA. Checksheet B will be transmitted by PWBA using Document Transmittal Form 217 (see Appendix C).

4. When PWBA returns Checksheet B Part Two to IRS with an entry in the "Action Taken" portion of the referral checksheet indicating that PWBA is taking no action, IRS will continue its examination in accordance with its existing procedures.

5. When PWBA returns Checksheet B Part Two with an entry indicating that it is taking action, PWBA will contact IRS to obtain information from IRS's file that PWBA needs to complete its planned action.

6. In all unagreed IRS cases involving Internal Revenue Code section 4971 or 4975, Form 6212-B (or a copy of Form 6212-B) will be completed with an entry in the box for "DOL Participation Requested." A copy of the report to the taxpayer (including a copy of the proposed 30-day letter) will be sent with a copy of the Form 6212-B. The Form 6212-B should be sent to the Area Director/District Supervisor at least 30-days prior to sending the report, including the 30-day letter, to the taxpayer. Contact must be made with the Area Director/District Supervisor in all unagreed cases. If PWBA declines to coordinate in the examination, the case file will be documented accordingly. Generally IRS should not close a case until 30-days from the date the Form 6212-B was sent to the Area Director/District Supervisor.

7. If IRS refers a Checksheet B to the Area Director/District Supervisor with an entry indicating that a violation of the fiduciary standards under Title I of ERISA or a violation of the ERISA prohibited transaction requirements has occurred, the referral will constitute a notice to the

Department of Labor within the meaning of section 3003(a) and 4975(h) of ERISA.

8. If IRS refers a Checksheet B to the Area Director/District Supervisor indicating that a violation of the minimum funding requirements of section 412 has occurred, the referral will constitute a notice to the Department of Labor within the meaning of section 3002(b) and 4971(d).

9. If IRS refers a Checksheet B to the Area Director/District Supervisor with an entry indicating that a fiduciary violation under Title I of ERISA has occurred with respect to an employee benefit plan and that IRS is considering action to disqualify the plan because the plan is also in violation of the exclusive benefit rule under the Internal Revenue Code, the agencies will process the case in accordance with section 103 of Reorganization Plan No. 4 of 1978. (See Appendix D.)

10. IRS will defer action in a case when as a result of a referral of a checksheet between the agencies, the PWBA Area Office advises the appropriate IRS Key District Office (Attn: Chief, EP/EO Division) in writing that the case has been referred to the DOL National Office. IRS will not take further action in the case until the date when PWBA notifies the Key District Office of PWBA's final action in the case, unless the provisions of Part II A.3.(e) become applicable.

C. Investigations Initiated by PWBA

1. PWBA Investigators/Auditors will complete Checksheet A, or Checksheet C, or both (as appropriate) during all civil on-site investigations.

2. If an entry on a completed checksheet requires a referral to IRS, the referral will be made not later than the earlier of (1) the date the investigation is closed by the Area Office (but at least 20 days before the closing letter is issued) or (2) the case is referred to the PWBA National Office. PWBA will refer checksheets in accordance with section A.3.a. of this Part, using Document Transmittal Form 217 (see Appendix C).

3. IRS will review any checksheet referred by PWBA, complete the "Action Taken" portion of the referral checksheet, and return Part Two to the Area Director/District Supervisor within 20 workdays of the date of the memorandum or other document transmitting the checksheet to IRS.

(a) If IRS returns Checksheet A or C Part Two to the Area Director/ District Supervisor with an entry indicating that IRS is taking no action in the case, PWBA will continue its investigation in accordance with its existing procedures. However, see Part V below regarding the information IRS must provide to DOL.

(b) If IRS returns Checksheet A or C Part Two to the Area Director/ District Supervisor with an entry indicating that IRS is taking action with respect to the referral, IRS will contact PWBA to obtain any additional information that IRS needs to complete its examination. If PWBA completed the checksheet with an entry in the "IRS Participation Requested" block, the agencies will coordinate their activities in the case. However, see Part V below regarding the information IRS must provide to DOL when the case is closed.

(c) IRS will defer action in a case when as a result of a checksheet referral between the agencies, the PWBA Area Office notifies the appropriate IRS Key District Office of any referral of the case to the DOL National Office in accordance with section B.10. of this Part.

4. When PWBA refers a Checksheet A to the IRS involving issues other than prohibited transactions, only the Form 5500 series return must be attached to the checksheet.

5. When PWBA refers a Checksheet A to the IRS that involves prohibited transaction issues, the following items must accompany the checksheet:

(a) Copy of Form 5500 series returns for all years in which a prohibited transaction was in effect.

(b) Available information about taxpayer/disqualified person including, particularly the EIN or SSN, address, educational level and possible name changes.

(c) Copy of plan and trust documents including restatements and/or amendments (only if IRS has not issued a determination letter on the plan and/or amendment). If the prohibited transaction is a loan to a plan participant, a copy of the loan provisions of the plan should be included.

(d) Copy of all PWBA correspondence related to the referred issue.

(e) Copy of the Report of Investigation (ROI) completed by PWBA investigator/auditor and related work papers. The work papers should include financial statements of trust, specific details of the prohibited transaction including copies of sale/transfer documents, repayment documents, contracts and agreements.

(f) A description of the current status of prohibited transaction, including possible correction.

(g) PWBA draft closing letter or, if applicable, the voluntary compliance letter. The closing letter will advise the taxpayer that (a)

a prohibited transaction has occurred, (b) the disqualified person(s) is/are required to file Form 5330, Return of Excise Tax Related to Employee Benefit Plans and where assistance in completing Form 5330 can be obtained.

(h) A description of the disqualified person's position regarding the prohibited transaction (if not contained in ROI).

(i) Any other information that documents the reason for the referral.

(j) Information in PWBA's possession concerning the fiduciary/disqualified person's filing or intent to file for bankruptcy.

6. If PWBA refers Checksheet C to IRS, the Form 990 (if applicable) and the items enumerated in Sections C.5.(a), (d), (e), and (i) of this Part will be attached.

7. When a PWBA Area Office refers a checksheet to the EP/EO Division of an IRS Key District concerning a violation of the prohibited transaction requirements, the EP/EO Division will, except in rare and unusual circumstances, take action to assess the excise tax under IRC section 4975 if: (1) the tax under section 4975(a) for any taxable year is at least the amount specified in Part VII of the Law Enforcement Manual; (2) 180 days or more remain before the expiration of the statute of limitations with respect to the prohibited transaction; and (3) the information described in section C.5 of this Part is attached to the checksheet when it is referred. If a case referred to an EP/EO Division satisfies the foregoing requirements and the Division fails to take action to assess the tax under section 4975(a), the case file will be annotated to reflect the reason for such failure and the appropriate explanation included in the "Remarks" of the checksheet and returned to DOL, as provided in Part V B.

III. IRS Appeals Office Procedures

The following procedures apply to all cases received by IRS Appeals Offices involving examinations of employee benefit plans within the meaning of section A.2. of Part II.

A. The Chief, Appeals Office (or designee) will complete and send the Form letter in Appendix E to the Area Director's/District Supervisor's Office as listed in Appendix A. To ensure that notice has been given to DOL as required by Sections 4971(d) and 4975(h) of the Internal Revenue Code, the Appeals Office shall follow the procedures of B. and C. of this part.

B. The Appeals Office will not take final action to settle the case, concede any Government issue, enter into a closing agreement with any taxpayer, issue any notice of deficiency with respect to taxes under section 4971 or 4975 that are not in jeopardy, or proceed with any action to revoke the favorable determination or qualification letter of any plan prior to the earlier of the date when the Appeals Office receives a response from PWBA or 60 days after the date of the Appeals Office's letter to PWBA.

C. PWBA will, within 60 days of the date of the letter from the Appeals Office, reply to the Appeals Office in writing if PWBA is taking any action concerning the referred case. If PWBA is taking action with respect to the case, the Appeals Office will coordinate with PWBA before taking any of the actions described in Section B. of this Part.

D. If the IRS Appeals Office, the Regional Director of Appeals and the PWBA Area Office are unable to reach agreement regarding disposition of the case, the matter will be forwarded to the IRS National Office, Director of Appeals to coordinate final resolution with the Associate Director, PWBA Office of Enforcement, DOL.

IV. Notification of Litigation

A. Litigation Involving IRS and Relating to the Administration of Title I of ERISA

1. The Director, Tax Litigation Division, Office of Chief Counsel (or designee), will forward to the DOL Solicitor (Attention: Associate Solicitor, Plan Benefits Security Division), and Associate Director, Office of Enforcement, PWBA, at the earliest possible date, a copy of any complaint or other opening pleading in litigation to which the IRS, the Treasury, the United States or any official thereof is party, either in Tax Court, Claims Court or in district court, and that presents issues relating to the administration of Title I of ERISA. Further pleadings in such matters will be furnished upon request.

2. The Director, Tax Litigation Division, Office of Chief Counsel (or designee), will notify the DOL Solicitor (Attention: Associate Solicitor, Plan Benefits Security Division), at the earliest possible date, whenever IRS determines that it will seek to intervene in any action in which the Secretary of the Treasury is entitled to do so under the provisions of ERISA section 502(h). The initial pleadings submitted on behalf of the Secretary will be forwarded to the Associate Solicitor. Further pleadings in such matters will be furnished upon request.

B. Litigation Involving DOL and Relating to Employee Benefit Plans

1. The Solicitor of Labor (or designee) will notify the Director, Tax Litigation Division, Office of Chief Counsel and the Chief, EP/EO Examination Branch, OP:E:O:E, when it is determined that litigation by DOL relating to employee benefit plans is warranted. Copies of the proposed complaint (or

other opening pleading and supporting documents) will be furnished to the Chief Counsel for review and to the Department of Justice for its assignment of primary litigative responsibility under the Memorandum of Understanding of February 11, 1975.

2. The Solicitor of Labor (or designee) will forward to the Director, Tax Litigation Division, a copy of any pleading filed naming the Secretary of Labor as a defendant and presenting issues relating to employee benefit plans. Further pleadings in such matters will be furnished upon request.

3. The Solicitor of Labor (or designee) will notify the Director, Tax Litigation Division at the earliest possible date whenever DOL determines that it will seek to intervene in any action in which the Secretary of Labor is entitled to do so under the provisions of ERISA section 502(h). The initial pleadings submitted on behalf of the Secretary will be forwarded to the Director. Further pleadings in such matters will be furnished upon request.

V. Tracking/Feedback

A. PWBA Area Offices and IRS District Offices will reconcile their listings of pending referrals at least once a quarter.

B. IRS Key District offices, upon closure of an examination initiated as the result of a referral from DOL, will forward to the Area Director/ District Supervisor Form 6212-A (or a copy of Form 6212-A) indicating the amount of Internal Revenue Code section 4971 or 4975 proposed or assessed excise tax. If IRS will not propose or assess excise taxes, then the reasons will be entered in the "Remarks" section of Form 6212-A.

C. IRS and DOL National Office personnel will meet at least quarterly to resolve any referrals on which the appropriate enforcement action is

in dispute. These quarterly meetings will also be used as a medium for resolving problems encountered by PWBA Area Offices and IRS Key District offices in following the provisions of this Agreement.

J.J. PICKLE, TEXAS, CHAIRMAN
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A.L. SINGLETON, MINORITY CHIEF OF STAFF
MICHAEL A. SUPERATA, COUNSEL TO THE MINORITY

August 30, 1988

Mr. Alan Leibowitz
Deputy Assistant Secretary
for Program Operations
Pension & Welfare Benefits Administration
Department of Labor
200 Constitution Avenue, N. W.
Washington, D.C. 20210

Dear Mr. Leibowitz:

I want to thank you for your testimony at the Oversight Subcommittee's hearings on the investment of pension plan assets. To complete our hearing record, I would appreciate having your responses to the attached questions by the close of business Friday, September 30, 1988.

Your attention to this matter is greatly appreciated. If any assistance is needed, please contact Rusty Guritz, Counsel, or Tom Arnold, Investigator, at 225-5522.

Sincerely,

J. J. Pickle, Chairman
Subcommittee on Oversight

JJP/tal
Enclosure

THE ENCLOSURE TO THIS LETTER WAS NOT REPRINTED SINCE THE DEPARTMENT OF LABOR REPEATED THE QUESTIONS IN THEIR RESPONSE.

10/14/88

U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington, D.C. 20210

RECEIVED
OCT 14 1988
Ways and Means
Subcommittee on Oversigh

October 13, 1988

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
House of Representatives
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to respond to your letter of August 30, 1988 to me in which you raised a series of questions as a follow-up to the topics discussed at the Subcommittee's hearing on July 12, 1985.

Enclosed are the answers to your August 30 letter. I hope these responses prove helpful to your Subcommittee.

Sincerely,

Alan Lebowitz
Deputy Assistant Secretary
for Program Operations

Enclosure

1

Question 1. How many pension plans is the Department of Labor responsible for monitoring? How many are plans with over 100 participants? How many are subject to fiduciary rules and requirements?

Answer: In 1987 approximately 915,000 private pension plans were subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA), as amended, and therefore under the Department's jurisdiction. About 51,000 of these plans covered 100 or more participants. The overwhelming majority of these plans are subject to ERISA's fiduciary responsibility rules, the primary exception being plans that are unfunded and maintained by employers primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.

The Department of Labor also has responsibility for the enforcement of provisions of the Federal Employees Retirement System Act of 1986 (FERSA), as amended, relating to fiduciary responsibilities with respect to the management of the Thrift Savings Fund.

Question 2. What specific record-keeping requirements are imposed on plans regarding investment and management of plan assets? Who has access to those records? How does one gain access to those records?

Answer: The record-keeping requirements under ERISA section 107 specifically require that every person subject to a requirement to file any description or report, or to certify any information under Title I of ERISA, maintain and keep available for examination records which will provide in sufficient detail the necessary basic information or data from which the reports or documents may be verified, explained or clarified, or checked for accuracy and completeness for a period of not less than six years. Various information concerning plan investments and the management of plan assets is required to be included under section 103 of ERISA as part of a plan's annual report. Accordingly, any records required to verify, explain, clarify, etc., such investment and management information required to be included as part of a plan's annual report must be maintained and made available for examination for a six year period.

These records must be made available to the Department upon examination of the plan. Such records would not ordinarily be required to be made available to participants and beneficiaries of the plan, except to the extent such records comprised part of the plan's annual report (Form 5500 Series). ERISA specifically requires that the latest annual report of the plan be made available for examination by participants and beneficiaries and that copies of such reports be furnished upon request. Annual reports also are required to be made available for inspection in the public disclosure room of the Department of Labor. In general, the annual report is required to include financial information

concerning the assets, liabilities, income and expenses of the plan, as well as schedules relating to assets held for investment at the end of the plan year and assets acquired and disposed of during the plan year. The extent to which a plan is required to comply with these annual reporting requirements will depend on, among other things, the size of the plan. In general, plans with fewer than 100 participants are required to file less information than larger plans.

Question 3. Are plans required to publish any information about the plan? About investments? Please explain.

Answer: Under Title I of ERISA, there are a number of documents that are required to be furnished to participants and beneficiaries and filed with the Department. These documents fall into two basic categories, those that relate to the substantive provisions of the plan and those that relate to the financial condition and operation of the plan.

With regard to the substantive provisions of the plan, the plan administrator is required to furnish to participants and beneficiaries, and in certain instances file with the Department, a summary plan description. The summary plan description is intended to describe, in a reasonably understandable manner, the rights, benefits and obligations of participants and beneficiaries under the plan in which they participate. When there are material changes in the plan or changes in the information required to be contained in the summary plan description, plan administrators are required to furnish participants and beneficiaries with a summary of those changes. At five year intervals, the summary plan description is required to be updated to integrate all the plan changes. After 10 years, a new summary plan description must be provided to participants and beneficiaries even if there are no changes, material or otherwise.

With regard to the financial condition and operation of the plan, the plan administrator is required to file with the Department an annual report, which contains basic financial and operational information about the plan. The annual report (Form 5500 Series) contains a variety of information concerning plan investment activities and investment performance, in addition to various schedules detailing the assets held for investment purposes during the plan year and an identification of significant transactions (e.g., those involving 5 percent or more of a plan's assets). A summary of the annual report information is required to be furnished to each participant and beneficiary annually. The format for this summary is prescribed in regulations promulgated by the by the Department.

In addition, plan administrators are required to make available copies of the latest annual report and the bargaining agreement, trust agreement, contract or other instruments under which the plan

is established or operated for examination by participants and beneficiaries. Copies of these documents are required to be furnished to participants and beneficiaries upon request; however, the administrator may make a reasonable charge to cover the cost of furnishing copies of these documents.

Copies of filed annual report forms (Form 5500 Series) and summary plan descriptions (and summaries of changes thereto) are maintained, for public inspection and copying, in the public disclosure room of the Pension and Welfare Benefits Administration.

Question 4. The Form 5500 (annual information return) requires that plans report the amount invested in stock. Can a plan participant find out from either the Department or from the plan what specific stock is owned by the plan at any given time? If so, how would a plan participant go about doing that?

Answer: The Form 5500 Series is the principal source of plan financial and investment information available to the Department. As I noted in my appearance before the Committee, for plans with more than 100 participants, the Form 5500 contains detailed information concerning the financial activities of the plan, including the precise investments that a particular plan has entered into. Any additional information concerning specific stock holdings, or changes in holdings from the time of the filing of the Form 5500, would be gathered in the course of a plan examination or investigation. While a plan administrator may, in response to a request from a participant or beneficiary, disclose the stock holdings of the plan on a given date, there is no specific statutory requirement that the administrator disclose such information to participants and beneficiaries. However, the administrator is required to make available to participants and beneficiaries copies of the latest annual report of the plan, which may, depending on the type of plan, include a schedule of assets held for investment at the end of the plan year and a schedule of the assets held for investment which were acquired and disposed of during the plan year.

Plans with fewer than 100 participants are not required to file schedules relating to assets held for investment as part of their annual reports. Accordingly, specific information concerning stock holdings may not be readily available to participants and beneficiaries or the Department for such plans.

Question 5. What statistics does the Department of Labor have on where pension plans are investing their money? What information regarding investments must pension plans report to the Department of Labor and when?

Answer: The Department of Labor tabulates annual aggregate statistics on the portfolio composition of private pension plans.

4

These data are based on a random sample of Form 5500 and 5500C reports.

Plans with 100 or more participants must provide, on their Form 5500 filed annually with the Department, a breakout of assets by type of investment. The Form 5500 also has schedules which provide detailed information on the assets held for investment purposes, nonexempt transactions involving a party-in-interest, loans and leases in default, and transactions in excess of five percent of the value of plan assets.

Plans with fewer than 100 participants file the less extensive Form 5500C report once every three years providing a portfolio distribution of plan assets. The other two years small plans may file a Form 5500R, which does not require the reporting of plan assets.

Question 6. What is the value of all plan assets? How much of that is in large plans? How much of those assets is invested? What is the traditional mix of investments in pension plans? How many investment transactions are conducted in one year by an "average" plan? What factors contribute to that activity?

Answer. In 1987, private pension plans held an estimated $1.6 trillion in plan assets. Approximately 83 percent of plan assets were held by plans with 100 or more participants. About 96 percent of all plan assets are invested, with most of the noninvested assets being receivables. In 1987, 35 percent of all invested assets were held in equities, 21 percent in corporate bonds, 12 percent in U.S. securities, 6% in deposits and currency, 2% in real estate, 7% in mortgages, 2% in mutual funds, and 1% in money market shares. The remaining 14% of all plan assets that were invested were in miscellaneous types of investments.

The average annual overall pension asset portfolio turnover rate is roughly 55 percent for assets held in equities. There are no data available at present on the turnover rate for total financial assets.

Question 7. What are the specific rules that you enforce in the investment area and what remedies are available to you?

Answer: ERISA generally requires that pension plan assets be held in trust by a trustee (unless the plan is funded through life insurance or is allowed the use of a non-trusteed custodial account). The trustee may have exclusive control over the investment of the plan assets or may be subject to the directions of a named fiduciary. Where the trustee is subject to the named fiduciary, it may follow the directions of that fiduciary only in those instances where such actions are in accordance with the plan

documents and not in violation of ERISA. A named fiduciary may, where permitted by the plan documents, appoint an investment manager to manage the plan assets if the appointment of the investment manager would be prudent under the circumstances. The investment of plan assets is subject to the fiduciary rules of Title I of ERISA. Those rules provide, among other things, that individuals or entities who exercise discretionary authority or control over the management of plan assets must act with the care, skill, prudence and diligence that a prudent man acting in a like capacity and familiar with such matters would use. ERISA also requires that plan assets be diversified and prohibits certain transactions. It provides statutory exemptions for certain transactions which otherwise would be prohibited, and also provides for an administrative exemption procedure.

Any fiduciary who violates ERISA's fiduciary rules concerning the investment of plan assets is liable for any losses suffered by the plan as a result of the breach and is liable to restore to the plan any profits which have been made by the fiduciary through the use of such assets. The fiduciary is subject to suit in federal court by the Secretary of Labor, plan participants, beneficiaries and other plan fiduciaries. ERISA also provides for injunctive actions and other equitable relief to enforce its fiduciary responsibility provisions. ERISA also authorizes the award of attorney's fees and court costs in the discretion of the courts. There are also criminal sanctions for certain activities.

Question 8: Does the Department of Labor review the Form 5500, that plans must file? What criteria are used to select plans for investigation?

Answer: Under an agreement between the Department of Labor and the IRS, the IRS receives all Annual Report Form 5500's that are filed by employee benefit plans and reviews them for accuracy and completeness. The IRS review of pension benefit plan filings differs in scope from that of welfare benefit plans reports. Many techniques are used by the Department of Labor to select plans for investigation through the use of computer review of the 5500s. These techniques primarily involve a combination of analyses of answers to narrative questions on the form and calculations of financial ratios and other information. Our policy is to preserve the confidentiality of our specific targeting techniques, because they constitute an important law enforcement tool. We and the IRS are now developing a greatly expanded system for automated review and analysis of 5500 forms.

Question 9. Please furnish several copies of completed Form 5500's from several different type and size plans.

Answer: Attached are several copies of completed Form 5500's from plans of different types and sizes, as you requested.

*NOTE: The examples of Form 5500 submitted are retained in the Subcommittee's hearing file.

Question 10. What is your total staff? Have your staffing levels increased in the last four years?

Answer: The Pension and Welfare Benefits Administration's total authorized staff for fiscal year 1989 is 511. In fiscal year 1988, 25 positions were added to carry out the Department's responsibilities under the Federal Employee's Retirement System Act, while 6 positions were transferred to special programs within the Department, resulting in a net increase of 19 positions for fiscal year 1988, which represents the only staff increase during the last four years.

Question 11. How many investigators do you have? How many attorneys? How many investigators have an accounting background? Where are your investigators located? In Washington? In field offices?

Answer: PWBA's total authorized staff for the enforcement program is 303 (266 in fifteen field offices and 37 in the Office of Enforcement) of which 234 are investigators, auditors or supervisors. PWBA has no positions classified as attorney positions, as the Departmental policy is that all attorney/legal functions are within the Office of the Solicitor. PWBA's enforcement program is supported by the attorneys in the Plan Benefits Security Division and the Special Litigation Division in the Office of the Solicitor, and by three of the Offices of Regional Solicitors who have been authorized by the Solicitor to support the enforcement efforts of seven of PWBA's field offices. There are approximately 41 positions that may have responsibility for assisting in the enforcement of ERISA in the Plan Benefits Security Division, the Special Litigation Division and the three Offices of Regional Solicitors.

Question 12. What enforcement activities do you conduct? Please describe.

Answer: ERISA imposes substantial law enforcement responsibilities on the Department of Labor relating primarily to the standards of fiduciary responsibility contained in the statute. Other federal laws impose additional law enforcement responsibilities on the Department in connection with employee benefit plans, primarily in the criminal area. The goal of these statutes is to assure the integrity and fairness of the private employee benefit plan system in the United States. Therefore, the Department's enforcement goal is to establish and maintain credible programs within its area of responsibility that support these national goals.

In this connection, PWBA concentrates its investigative resources in certain areas where it is expected that there exist serious abuses and PWBA can have a substantial impact. In December 1986, the Department issued its ERISA Enforcement Strategy Implementation

Plan, which described and explained the enforcement strategy which would be immediately implemented by PWBA. The enforcement strategy provides that fifty percent of PWBA's fiduciary investigative time shall be devoted to investigating two significant issues: (1) abusive practices of service providers to welfare plans and (2) abusive practices of financial institutions that manage and invest the assets of pension plans. PWBA also conducts general investigations involving the full range of ERISA covered plans and violations. In addition, we have responsibility to conduct investigations of possible violations of federal criminal laws that affect employee benefit plans.

The Federal Employees Retirement System Act also imposes enforcement responsibilities on the Department of Labor primarily related to the standards of fiduciary responsibility contained in the statute, which are similar to fiduciary responsibility provisions of ERISA. Specifically, the Secretary is directed to establish a program of audits to determine the level of compliance with the fiduciary responsibility provisions of the Act as they relate to the Thrift Savings Fund.

Question 13. How many cases do you currently have on hand? How many of those deal with plan investment practices? How many did you open last year? How many did you close? How many cases were closed without action?

Answer: As of August 31, 1988, PWBA had open 1,590 investigations. Of that total, 1,551 investigations involved potential civil violations of ERISA, and the remaining 39 cases were criminal investigations which involved employee benefit plan assets.

As you know, PWBA investigates a number of different entities which have fiduciary responsibility for employee benefit plan assets. These entities include pension plans, welfare plans and, in accordance with the ERISA Enforcement Strategy Implementation Plan, financial institutions and service providers to employee benefit plans. The majority of our investigations relate to pension plans and would generally include investment practices. We do not, however, maintain precise data in this area.

PWBA opened a total of 1,471 investigations in FY 1987. Of that total, 1,455 of the opened cases involved potential civil violations of ERISA, and the remaining 16 opened cases involved potential criminal violations which affected employee benefit plan assets.

PWBA closed a total of 1,686 investigations in FY 1987. Of that total, 1,661 of the closed cases were civil investigations under ERISA, and the remaining 16 closed cases were criminal investigations. The total monetary recoveries in FY 1987 were $117 million of which $40 million were assets restored to employee

benefit plans and $77 million were reversals of prohibited transactions.

In FY 1987, 687 cases resulted in findings of violations of ERISA. In a majority of these cases, corrections were obtained which directly affected employee benefit plan assets and participants; the remaining closed investigations corrected violations of ERISA such as obtaining the correct fidelity bond or correcting an annual report Form 5500 series filing.

Question 14. Do you refer and coordinate case work with IRS, your Inspector General's office, and the Department of Justice? Please explain how it works.

Answer: Coordination with the IRS: The Department of Labor and the IRS have entered into an agreement for coordination of investigations of employee benefit plans. Pursuant to the procedures established in the coordination agreement, PWBA notifies the IRS of the names of plans it has selected for civil investigation. As unscheduled investigations are conducted, PWBA also notifies the IRS of that action as soon as possible. The IRS and the Department have developed checksheets for determining whether issues presented in an examination/investigation by one agency should be referred to the other agency. In every examination/investigation, the referring agency completes the appropriate checksheet. After receiving a referral, an agency may request additional information from the referring agency with respect to the plan involved. In addition, procedures are in place which require the agencies to notify each other regarding proposed action, including litigation, against specific plans.

Coordination with the Inspector General's Office: PWBA and the Department of Labor's Office of the Inspector General Office of Labor Racketeering (OLR) have entered into a memorandum of understanding to improve the effectiveness of the Department's enforcement activities in relation to organized crime and racketeering infiltration, control, and influence in the employee benefit plan field, and to strengthen the protection afforded to employee benefit plan participants and their beneficiaries. OLR and PWBA have agreed to exchange information in investigations involving matters of interest to both agencies. The agreement provides a mechanism for PWBA and OLR to cooperate to achieve Departmental objectives in connection with the administration of ERISA.

PWBA provides OLR with a list of all matters currently under investigation which can reasonably be considered to contain matters within the jurisdiction of OLR. In addition, PWBA provides OLR with a list of all benefit plans targeted for audit which are affiliated with unions within industries identified by OLR.

Coordination with the Department of Justice: The Departments of

Labor and Justice have entered into a memorandum of understanding relating to the matters under Title I of ERISA. Among other things, subject to the direction of the Attorney General, the memorandum gives primary responsibility for the preparation and presentation of most civil cases arising in the district courts and courts of appeals under ERISA to attorneys in the Office of the Solicitor of Labor. The memorandum provides that all cases involving criminal provisions of ERISA will be prosecuted by the Department of Justice. The Department also coordinates on an as needed basis with the FBI, United States Attorneys and other state and local enforcement agencies. The Department also has formal and informal coordination arrangements with the five federal banking agencies and the Securities and Exchange Commission, as well as with numerous state agencies.

Question 15. Please describe recent examples of real cases where the primary enforcement issue concerns plan investments.

Answer: McLaughlin v. Harmon (D.C. Utah, 8/29/88): The Department obtained a $4 million consent judgment against a large supermarket chain and the former trustees of its profit sharing plan which covers over 800 participants. The Department's complaint alleged that the former trustees, who were also officers and directors of the corporate defendant, violated ERISA's fiduciary and diversification provisions by, among other things, causing the plan to make inadequately secured loans of more than $6 million to a realty company at a time when its deteriorating financial condition made it a poor credit risk, accepting from the realty firm encumbered and overvalued property in lieu of cash, and making over $1 million in inadequately documented and inadequately secured loans to parties in interest.

Brock v. Santiago (D. P.R., 6/17/88): The Department obtained a court order requiring four trustees of a Teamster pension plan in Puerto Rico to repay $1,010,000 to the plan. The Department's complaint alleged that plan trustees violated ERISA when they invested plan funds in developing, constructing and operating a hotel and casino because, among other things, they failed to diversify plan investments and to discharge their duties for the exclusive purpose of benefiting the plan, and they disregarded the recommendation of plan advisors in making the investment.

McLaughlin v. Montana Bancsystem, Inc. (D. Mont., 7/18/88) The Department obtained a consent decree from the Federal District Court of Montana requiring a bank holding company and members of the advisory committee of its employee stock ownership plan (ESOP) to transfer 54,000 shares of its stock to the plan and to independently appraise all future purchases of the stock. The stock transfer represented a recovery of approximately $380,000 for the plan. The Department's complaint alleged that the defendants violated ERISA when, among other things, they paid more than

adequate consideration for the shares of stock which they acquired from the bank and related parties for the ESOP.

Brock v. Tower Asset Management, Inc. (S.D.N.Y., 3/6/87): The Department has filed a civil complaint against Tower Asset Management, Inc. of New York City and others, alleging that approximately $31 million of assets of two pension plans were improperly invested in speculative maritime and other investments. Tower served as the investment manager to the plans during the period the investments were made, and the assets entrusted to Tower for investment declined in value from $31 million to about $9.5 million.

Question 16. Do you recommend any statutory changes to facilitate enforcement and compliance in this area?

Answer: We are not prepared to make any specific recommendations at this time.

Mr. ANTHONY. The next panel is the U.S. General Accounting Office, Joseph Delfico, Associate Director, Human Resource Division; and Jack VanDerhei, Adjunct Senior Research Associate, Employee Benefit Research Institute.

Per Chairman Pickle's statement, your entire statement will be accepted for the official record, and at this time you are permitted to continue as you see fit.

STATEMENT OF JOSEPH F. DELFICO, SENIOR ASSOCIATE DIRECTOR, HUMAN RESOURCES DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JOHN HANSEN, HARRY JOHNSON, AND GARY TUTT

Mr. DELFICO. Thank you. Mr. Chairman and members of the committee, with your permission, I would like to submit my full testimony, and I thank you for submitting it in the record.

With me today are John Hansen, Harry Johnson, and Gary Tutt, who were major contributors to this assignment. I am pleased to be here to discuss the results of our analysis of how the 1987 stock market decline affected the value of assets of a selected group of large pension plans.

You expressed concern about the potential adverse effects the stock market decline had on pension plans and asked us to look into the matter. In response to your request, we reviewed calendar year 1987 investments of selected plans with large amounts of assets. Our objectives were to ascertain how the 1987 stock market decline affected the plans' assets, whether there was a relationship between the proportion of funds invested in stock and the changes in the plans' asset values and how defined benefit and defined contribution plans fared during the market decline.

We obtained information from officials representing 174 plans sponsored by 92 private employers and unions. As of December 31, 1987, the 174 plans had total assets of about $300 billion, or about 19 percent of all private pension assets. The plans include 89 defined benefit plans with $229 billion in assets and 6.4 million participants. In 1985, defined contribution plans were $70 billion in assets and 2.75 million participants.

Overall, the total assets of the 174 plans decreased by about $34.5 billion during the fourth quarter of 1987 but still increased by $17.1 billion for the year. Although the assets of the 158 plans decreased during the fourth quarter, 154 plans out of the 174 in our sample increased in value for the year.

There are several reasons why the plans were not more seriously affected by the stock market decline. The primary reason is that the plans' total assets increased by 18 percent during that first 9 months of 1987. Of the plans we surveyed, 168 had increases during this period with 117 gaining more than 15 percent.

Another reason was that most plans diversified their assets among investments other than stock. On September 30, 139 plans had at least 30 percent of their portfolio in assets other than stock. The stock market's partial recovery by December 31 also helped mitigate the declining effects on plan assets for the year.

Generally the plans that had a majority of their assets in stock on January 1 gained more in asset value during the first 9 months

of 1987 when the stock market was rising than plans with smaller portions in stock. For example, most plans with a majority of their assets in stock at the start of the year had an asset increase greater than 15 percent during the first 9 months. In contrast, about half of the plans with a minority of their assets in stock had increases of 15 percent of less.

There were, however, some significant exceptions to this pattern. During the fourth quarter when the stock market decline occurred, plans with the majority of their assets invested in stock had greater asset decreases than plans with smaller portions in stock. Two-thirds of the plan with the majority of their assets in stock on September 30 had asset decreases of more than 10 percent by December 31.

On the other hand——

Mr. ANTHONY. Would you yield? Does that mean the increase was for the entire year or just that part?

Mr. DELFICO. That was for just that part.

On the other hand, two-thirds of the plans with a minority of their assests in stock had asset decreases of 10 percent or less, and the other one-third of this group actually experienced increases during the last quarter.

Again, there were some significant exceptions to the pattern. During the fourth quarter of 1987, most of the defined benefit plans had decreases in asset values of up to 19 percent, the largest gain for six plans that had an increase in the asset value was 5 percent for the quarter.

For the year, however, most of the defined benefit plans had increases in asset values ranging up to 27 percent. Only the three plans that had asset decreases ended up with slightly less assets to cover benefits owed.

Of the defined contribution plans surveyed, most had asset decreases during the fourth quarter ranging up to 27 percent, with 10 having asset gains up to 5 percent. For the year, most of the defined contribution plans had gains ranging up to 45 percent with 17 plans having decreases of up to 35 percent.

The value of a participant's benefit in the defined contribution plan generally fluctuates with the change in plan assets. The wide range of asset increases and decreases experienced during the year by the plans we surveyed demonstrates that participant benefits can rise and fall sharply within a short period. One plan's assets increased 28 percent in the first 9 months of the year, but decreased 27 percent during the fourth quarter and 6 percent for the year overall. Another plan's assets increased 86 percent in the first 9 months, decreased 23 percent in the last quarter but were up 44 percent for the year.

The total asset value of surveyed plans decreased substantially during the last quarter of 1987 when the stock market decline occurred. However, the decreases were more than offset by gains during the first 9 months of the year, with most plans experiencing increases in assets for the year.

Also the plans' total investments performed better on the average for the year than often-use stock market indices. The extent of growth in the stock market from 1982 to 1986 likely had a much greater impact on the increasing plan assets than the October 1987,

stock market decline had on reducing them. With some significant exceptions, the asset increases and decreases in the surveyed plans during the first 9 months and the fourth quarter of the year were related to the proportion of assets in stock. The exceptions to the relationship strongly suggest that other factors, such as asset diversification, the quality of individual investments, and the timing of buy and sell transactions, also affected the plan asset increases and decreases.

Most defined benefit plans we surveyed fared about the same, gaining in asset values in the first 9 months of 1987, declining during the fourth quarter when the market decline occurred and increasing in asset value for the year. However, for the year a larger percentage of the defined contribution plans had asset decreases. As a whole, the asset changes of defined contribution plans were more volatile and disbursed than defined benefit plans.

The poorest performing defined contribution plans lost more than the poorest performing defined benefit plans, and the best performing defined contribution plans gained more than the best performing defined benefit plans.

This completes my statement. I would be happy to answer any questions.

[The statement of Joseph F. Delfico follows:]

STATEMENT OF JOSEPH F. DELFICO, SENIOR ASSOCIATE DIRECTOR, HUMAN RESOURCES DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our analysis of how the October 1987 stock market decline affected the value of assets of a selected group of large pension plans.

BACKGROUND

Private pension plans are an important source of retirement income promised to millions of retired and working Americans. The financial position of pension benefits has improved significantly in recent years, largely due to an enormous increase in plan assets. From 1982 through 1986, total plan assets reportedly doubled. By 1987, there were about $1.6 trillion in pension plan assets, and most defined benefit plans (benefits based on such factors as compensation and years of service) had more assets than needed to pay for earned benefits.

The Employee Retirement Income Security Act (ERISA) established requirements to help prevent large losses of pension plan assets. Generally, ERISA's fiduciary provisions require diversified investment of plan assets to help minimize losses, but certain defined contribution plans (benefits based on the amount in a participant's account) are exempt from the requirements. The exempt plans include those designed to invest primarily in the securities of the sponsoring employer, such as stock bonus and employee stock ownership plans.

ERISA's diversification provisions allow plan officials substantial investment flexibility. The provisions require plan assets to be invested prudently, but generally do not specify the degree of diversification required. For plans subject to the diversification provisions, ERISA prohibits the investment of more than 10 percent of plan assets in the sponsoring employer's securities.

A major factor contributing to the increase in pension assets was the extensive growth of the stock market. The Dow Jones Industrial Average, an often-used indicator of the stock market's performance, more than doubled from 875 points at the beginning of 1982 to 1,927 points at the end of 1986.

During the first 8 months of 1987, the stock market's value, as measured by the Dow, continued to grow--increasing by almost 800 points, to an all time high of 2,722. By October 1, however, the Dow had dropped by 126 points, and it fell another 350 points during the first 18 days of October. The decline culminated on October 19, when the Dow plunged a record 508 points (23 percent)--comparable, in percentage terms, only to the October 1929 stock market crash. During the first 19 days of October, the Dow lost about 34 percent of its total value--almost $1 trillion.

OBJECTIVES, SCOPE AND METHODOLOGY

Mr. Chairman, you and the Chairman and other members of the Senate Committee on Governmental Affairs expressed concern about the potential adverse effects the stock market decline had on pension plans, and asked us to look into the matter. In response to these requests, we reviewed the calendar year 1987 investments of selected plans with large amounts of assets.

Our objectives were to ascertain (1) how the 1987 stock market decline affected the plans' assets, (2) whether there was a relationship between the proportion of funds invested in stock and the changes in the plans' asset values, and (3) how defined benefit and defined contribution plans fared during the market decline.

We focused on private employers and unions that sponsored plans with large amounts of assets because they (1) included a large portion of total pension assets and (2) covered a large number of participants. By telephone, we attempted to obtain information on the largest defined benefit and defined contribution plans maintained by 117 private plan sponsors having the largest amount of pension assets.

We obtained information from officials representing 174 plans sponsored by 92 private employers and unions. As of December 31, 1987, the 174 plans had total assets of about $300 billion, or about 19 percent of all private pension assets. The plans included 89 defined benefit plans with $229 billion in assets and 6.4 million participants, and 85 defined contribution plans with $70 billion in assets and 2.75 million participants.

We obtained information on each plan's assets as of January 1, September 30, and December 31, 1987. We adjusted reported plan assets for contributions and distributions made during the year to minimize their effect on analyses of asset value changes. We also obtained plan officials' views on the effect of the stock market decline on their plans. Our findings apply only to the plans we surveyed and should not be generalized beyond these large plans.

ASSET DECREASES DURING MARKET DECLINE MORE THAN OFFSET BY EARLIER GAINS

Overall, the total assets of the 174 plans decreased by about $34.5 billion (10.3 percent) during the fourth quarter of 1987, but still increased by $17.1 billion (6 percent) for the year. Although the assets of 158 plans decreased during the fourth quarter, 154 increased in value for the year. For the year, the percentage increase in the plans' total assets exceeded the gains of two often-used stock indices. The Dow increased by less than 1 percent for 1987, and the Standard & Poor's 500 index, a broader measure of the stock market's performance, gained 2 percent.

There are several reasons why the plans were not more seriously affected by the stock market decline. The primary reason is that plans' total assets increased by $51.5 billion (18.3 percent) during the first 9 months of 1987. Of the plans we surveyed, 168 had increases during this period, with 117 gaining more than 15 percent.

Another reason was that most plans diversified their assets among investments other than stock. On September 30, 139 plans had at least 30 percent of their portfolio in assets other than stock, with 110 having 40 percent or more in other assets. The average asset portfolio on September 30 was about

-- 56 percent in stock,

-- 19 percent in bonds,

-- 14 percent in cash and equivalents, and guaranteed investment contracts (a fixed income investment that provides a fixed rate of interest), and

-- 11 percent in other investments, such as real estate, mortgages and mortgage-backed securities, and annuities.

Pension plans have often been associated with the use of hedging devices, such as options and futures, to minimize the risk of large losses. However, information provided by plan officials indicates that this was not the case for most plans that we surveyed. Of the 174 plans, 25 (about 14 percent) had

assets in hedging devices on September 30--just before the stock market crash. All but one of the hedged plans were defined benefit plans.

Representatives of the 25 hedged plans had different views on the extent to which the hedging devices limited their losses during the stock market crash. One-third of them said that hedging had a moderate to very significant effect on limiting their losses, but the other two-thirds said that the impact of hedging was, at best, minor.

The stock market's partial recovery by December 31 also helped mitigate the decline's effect on plan assets for the year. Between October 19 and the end of the year, the Dow rose by 200 points. It is likely that the plans we surveyed benefited from the partial recovery because they continued to hold large portions of their assets in stock. Nine out of 10 plans told us they did not change their investment policy (most of which included investment in stock) as a result of the crash. As of December 31, 1987, the 174 plans still had about 47 percent of total assets in stock.

ASSET CHANGES GENERALLY RELATED TO STOCK HOLDINGS

Generally, the plans that had a majority of their assets in stock on January 1 gained more in asset value during the first 9 months of 1987, when the stock market was rising, than plans with small proportions in stock. For example, most plans with a majority of their assets in stock at the start of the year had asset increases greater than 15 percent during the first 9 months. In contrast, about half of the plans with a minority of their assets in stock had increases of 15 percent or less.

There were, however, some significant exceptions to this pattern. At one extreme, a plan with about 98 percent of its assets in stock on January 1 experienced a 26-percent decline in asset value by September 30, while two plans with less than 20 percent of their assets in stock experienced increases of slightly more than 20 percent.

During the fourth quarter, when the stock market decline occurred, plans with a majority of their assets invested in stock had greater asset decreases than plans with small proportions in stock. For example, two-thirds of the plans with a majority of their assets in stock on September 30 had asset decreases of more than 10 percent by December 31. One increased in asset value during the quarter. On the other hand, two-thirds of the plans with a minority of their assets in stock had asset decreases of 10 percent or less, and the other one-third had increases up to 5 percent.

Again there were some significant exceptions to the pattern. For example, two plans with more than 60 percent of their assets in stock lost less than 2 percent in asset value during the quarter. One plan with 36 percent of its assets in stock lost about 16 percent in asset value.

The exceptions to the pattern of asset changes and the stock market's performance in the first 9 months and the fourth quarter of 1987 are not surprising. Such factors as the diversification of investment portfolios, the quality of individual investments, and the timing of buy and sell transactions can greatly influence performance. These factors were also working to affect plan asset values during 1987.

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DEFINED CONTRIBUTION PLANS' PERFORMANCE VARIED MORE WIDELY THAN DEFINED BENEFIT PLANS'

Changes in plan assets affect employers and participants differently for defined benefit and defined contribution plans. In defined benefit plans, employers' promises are generally framed in terms of the benefit to be paid. Employers are responsible for ensuring that there are sufficient assets to pay these promised benefits; they bear the risk of investment losses and realize the benefits of gains. In defined contribution plans, employers' promises are generally limited to making contributions to the plan. Plan participants bear the risk of investment losses and realize the benefits of investment gains.

During the fourth quarter of 1987, 83 of the 89 defined benefit plans had decreases in asset value of up to 19 percent. The largest gain for the 6 plans that had increases in asset value was 5 percent for the quarter. For the year, however, 86 of the defined benefit plans had increases in asset value ranging up to 27 percent. Only the three plans that had asset decreases (from 2 to 7 percent) ended up with slightly less assets to cover benefits owed.

Of the 85 defined contribution plans surveyed, 75 had asset decreases during the fourth quarter ranging up to 27 percent, with the other 10 having asset gains of up to 5 percent. For the year, 68 of the defined contribution plans had gains ranging up to 45 percent, with the remaining 17 plans having decreases of up to 35 percent. (Attachment 1 shows the percentage change in assets for the year for the surveyed defined benefit and defined contribution plans.)

The value of a participant's benefit in a defined contribution plan generally fluctuates with changes in plan assets. The wide range of the asset increases and decreases experienced during the year by the plans we surveyed demonstrates that participants' benefit values can rise and fall sharply within a short period.

For example, one plan's assets increased 28 percent in the first 9 months of the year, but decreased 27 percent during the fourth quarter and 6 percent for the year. Another plan's assets increased 86 percent in the first 9 months, decreased 23 percent in the last quarter, and were up 44 percent for the year.

CONCLUDING OBSERVATIONS

The total asset value of the surveyed plans decreased substantially during the last quarter of 1987, when the stock market decline occurred. However, the decreases were more than offset by gains during the first 9 months of the year, with most plans experiencing increases in asset values for the year. Also, plans' total investments performed better, on the average for the year, than often-used stock indices. The extensive growth in the stock market from 1982 through 1986 likely had a much greater impact on increasing plan assets than the October 1987 stock market decline had on reducing them.

With some significant exceptions, the asset increases and decreases in surveyed plans during the year were related to the proportion of assets in stock, and the rise and fall of the stock market. The exceptions to the relationship strongly suggest that other factors, such as asset diversification, the quality of individual investments, and the timing of buy and sell transactions, also affected plan asset increases and decreases.

Most defined benefit and defined contribution plans we surveyed fared about the same--gaining in asset value in the first 9 months of 1987, declining during the fourth quarter when

the market decline occurred, and increasing in asset value for the year. However, for the year, a larger percentage of the defined contribution plans had asset decreases. As a whole, the asset changes of defined contribution plans were more volatile and dispersed than defined benefit plans. The poorest performing defined contribution plans lost more than the poorest performing defined benefit plans, but the best performing defined contribution plans gained more than the best performing defined benefit plans.

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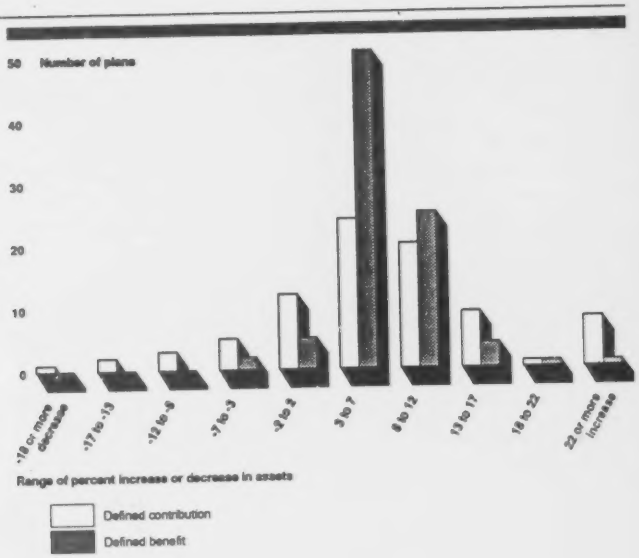
Mr. Chairman, this completes my statement. I would be happy to answer any questions at this time.

ATTACHMENT 1

ATTACHMENT 1

Percent Change in Assets of Defined Benefit and Defined Contribution Pension Plans (January to December, 1987)



STATEMENT OF JACK L. VanDERHEI, PH.D., ADJUNCT SENIOR RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Mr. VANDERHEI. Chairman Pickle, we wish to commend you for your continued pursuit of the policy issues surrounding the Nation's retirement income system, and we are honored to provide the subcommittee with our analysis of the impact of the recent fluctuation of the stock markets on the financial stability and investment practices of pension plans.

In particular, we are restricting our remarks this afternoon to the evidence gathered from aggregate statistics on pension plans. This is in no way meant to down-play the importance of studying this phenomenon on an individual plan basis, and the type of analysis presented by the previous witness is extremely valuable in this regard. The written analysis we have submitted to the subcommittee contains a literature review of other microbased studies that have appeared in the financial press, and we hope that this will be useful in your future deliberations.

We have also chosen to focus our comments today on private, rather than public, and trusteed, rather than insured, pension plans. Although public plans and private insured funds are significant, each with approximately $0.5 trillion in assets, no data are currently available on the effect of the market decline on their entire portfolio of assets. Discussion of both types of pension plans are included in our written testimony, however.

Before I begin, I would like to point out that the Employee Benefit Research Institute is a nonprofit, nonpartisan, public policy research institution. In keeping with the institute's standard policy, we will not be making recommendations or advocating any particular policy position. Rather, we will strive to provide the subcommittee with an analytical framework for making its own evaluation of this important question.

I would also like to take this opportunity to thank Jennifer Davis for appearing with me today and Joseph Piacentini for coauthoring the written testimony. Ms. Davis and Mr. Piacentini are the two staff members of the institute directly responsible for producing the quarterly pension investment report developed jointly by the Institute and the Federal Reserve Board using data compiled by Wilshire Associates. Since I began my affiliation with the institute last month, they have been extremely helpful in educating me on the technical aspects of the reports. However, as I have not had time to review the entire estimation program prior to this testimony, I asked Ms. Davis to answer any questions relating to this procedure that may arise today.

I would like to start out with just a few aggregate statistics that we have developed from this data base.

Chairman PICKLE. Would you please speak into the microphone.

On Monday, October 19, 1987, the Dow Jones Industrial Average dropped a record 508 points, or 23 percent, causing great concern throughout financial markets. As expected, private trusteed pension funds, with direct and indirect stock holdings totalling $590 billion—45 percent of total fund assets—obviously suffered large losses.

Findings from the quarterly pension investment report shed some light on the impact of the market decline on these pension funds and on their behavior in the stock market during the fourth quarter of 1987. First of all, the study reveals that the funds did not react to the decline by fleeing the market. And, second, although fourth quarter investment losses were large, they did not fully offset gains realized during the first three quarters of the year.

On net, these pension funds neither bought nor sold stock to any large extent during the fourth quarter—that is, stock sales were offset by stock purchases of equal value. This compares with a net sale of $14 billion in stock during the third quarter of 1987 and $35 billion during the first three quarters of the year.

Overall, these pension funds suffered net losses of $135 billion—10 percent of total assets—during the fourth quarter of 1987. Net capital losses of $152 billion were partially offset by dividend payments and interest income of $18 billion. As expected, fourth quarter losses relative to total assets increased with the proportion of total assets invested in stock.

Single-employer defined contribution funds had 42 percent of total assets invested directly in stock and lost 12 percent of total assets. Single-employer defined benefit funds—40 percent in stock—lost 10 percent of total assets; while multiemployer plans—29 percent in stock—lost only 6 percent of total assets.

The gains made during the first three quarters of 1987 combined to offset fourth quarter losses, for a total 1987 rate of return equal to 6.1 percent. Even direct stock holdings, which were responsible for most of the fourth quarter loss, showed a positive return for the year. Furthermore, total 1987 returns were positive for all major plan types. Single-employer defined benefit and defined contribution funds both realized returns in excess of 6 percent, while multiemployer funds realized a 3.6 percent return.

Although these pension funds generally did not sell their stock during the fourth quarter, the overall investment mix of these funds did change. Direct holdings of corporate equity fell from 40 percent of their total assets to 36 percent, primarily due to the decline in value of stock holdings.

I would like to finish with a list of eight conclusions based on our written testimony:

One, the aggregate level of pension funds at the end of 1987 exceeded the level established at the end of 1986.

Two, net sales of equities was not unusually large when viewed in a time series perspective.

Three, investment gains produced in the first three quarters of 1987 more than offset the losses recognized in the fourth quarter of that year.

Four, direct holdings of equities by pension funds declined marginally in the fourth quarter of 1987.

Five, portfolio insurance, as implemented by some firms, was not completely successful in limiting equity losses during the market decline.

Six, it appears that the majority of pension funds did not have portfolio insurance programs in place during October 1987.

Seven, defined contribution plan participants suffered short-term losses to the extent their investments included equities. ESOP participants may have suffered the largest losses. Unfortunately, the diversification requirements added by the Tax Reform Act of 1986 have not been in force long enough to be of any real value to ESOP participants nearing retirement age.

Eight, the overall impact of the market decline cannot be viewed in isolation. Trustees are simultaneously responding to incentives created by increased volatility in the financial markets as well as the pension accounting practices mandated by the Financial Accounting Standards Board and several new provisions enacted by the Omnibus Budget Reconciliation Act of 1987, including a new exposure-related premium for the Pension Benefit Guaranty Corporation, more rigorous minimum funding standards for underfunded plans and a more restrictive full funding limitation for overfunded plans. The net effect of these changes may be to make trustees more conservative as to investment management.

That concludes my remarks. I would like to thank you for this opportunity to testify and I would be happy to answer any questions.

[The statement of Messrs. VanDerhei and Piacentini follows:]

The Impact of the October 1987 Stock Market Decline on Pension Plans

Statement of
Jack L. VanDerhei, Ph.D., Adjunct Senior Research Associate
and
Joseph S. Piacentini, Research Analyst
Employee Benefit Research Institute

The stock market collapse of October 1987, which followed 5 years of bull markets, called new attention to the risks associated with various pension fund investment strategies. For example, it highlighted questions about the appropriate level of equity exposure for pension funds and the effectiveness of portfolio insurance. This testimony presents data and surveys the literature on the effect of the market collapse on pension plans and on the behavior of pension funds during the fourth quarter of 1987.

Aggregate Statistics

Data on private trusteed pension funds reported here were developed by the Employee Benefit Research Institute (EBRI) and the Federal Reserve Board (FRB) using Trust Universe Comparison Service data compiled by Wilshire Associates (Wilshire-TUCS). EBRI publishes these estimates on an ongoing basis in its Quarterly Pension Investment Report (QPIR). State and local government pension data are drawn from the FRB's Flow of Funds (FOF) publications. Data on private insured pension reserves are tabulated from the American Council of Life Insurance's Life Insurance Factbook.

On Monday October 19, 1987, the Dow Jones Industrial Average dropped a record 508 points, or 23 percent, causing great concern throughout financial markets. Private trusteed pension funds, with direct and indirect stock holdings totalling $590 billion (45 percent of total fund assets) as of September 30, suffered large losses. State and local government pension funds, which held $226 billion in stock (40 percent of total assets) on September 30, were adversely affected as well.

Private Trusteed Pension Funds

Findings from the EBRI/FRB pension investment database study shed some light on the impact of the market decline on private trusteed pension funds and on the behavior of these pension funds in stock markets during the fourth quarter of 1987. The study reveals that these funds did not react to the decline by fleeing the market. And, though fourth quarter investment losses were large, they did not fully offset gains realized during the first three quarters of the year.

On net, private trusteed pension funds neither bought nor sold stock to any large extent during the fourth quarter of 1987 (that is, stock sales were offset by stock purchases of equal value). This compares with a net sale of $14 billion in stock during the prior quarter and $35 billion during the first three quarters of the year. The results did vary by type of plan however. Defined benefit plans and multiemployer plans were net sellers of equity during this quarter with sales of $7.1 billion and $0.5 billion respectively. Based on asset allocations at the end of the third quarter of 1987, this represents 2.4 percent of all equities held by defined benefit plans and 1.3 percent for multiemployer plans. Defined contribution plans, however, were net buyers of equities during this quarter with net purchases of $7.2 billion (3.6 percent of the total in the previous quarter).

It should be noted that, in the case of defined benefit pension plans, the net sales of equities during the market decline is not a new development. In fact, an analysis of the time series for this figure reveals that defined benefit pension plans were net sellers of equities in each quarter from the first quarter of 1985 to the first quarter of 1988. Moreover, the sales of equities by defined benefit pension plans in the fourth quarter of 1988 varied by plan size. Defined benefit plans with more than $75 million in assets had net sales equal to 3.6 percent of existing equity levels while defined benefit pension plans with assets less than that amount had net sales of equities of only 0.6 percent of existing levels.

Overall, private trusteed pension funds suffered net losses of $135 billion, or

10.4 percent of total assets, during the fourth quarter of 1987. This is the largest loss recorded during the last five years. Net capital losses of $152 billion were partially offset by dividend payments and interest income of $18 billion. Among plan types, fourth quarter 1987 losses relative to total assets increased with the proportion of total assets invested in stock. Single-employer defined contribution funds, with 42 percent of total assets invested directly in stock on September 30, lost $55 billion, or 12.0 percent of total assets. Single-employer defined benefit funds (40 percent in stock) lost $71 billion (10.1 percent of total assets); multiemployer plans (29 percent in stock) lost $8.1 billion (6.3 percent of total assets).

The gains made during the first three quarters of 1987 combined to offset fourth quarter losses, for total 1987 earnings of $69 billion, or 6.1 percent. Even direct stock holdings of private trusteed funds, responsible for most of the fourth quarter loss, showed a positive return for the year. Furthermore, total 1987 returns were positive for all plan types. Single-employer defined benefit and defined contribution funds realized returns of 6.4 percent and 6.6 percent respectively, while multiemployer funds realized a 3.6 percent return.

Although private trusteed pension funds generally did not sell their stock during the fourth quarter, the overall investment mix of these funds did change. Direct holdings of corporate equity fell from 40 percent of their total assets to 36 percent, primarily due to the decline in value of stock holdings.

Private Insured Pension Reserves

No data are currently available on the effect of the October 1987 stock market decline on private insured pension reserves. Presumably, any effect on the 79 percent of insured reserves that are backed by general accounts was limited by state regulations restricting common stock investments of general accounts. In addition, in 1986 total assets of U.S. life insurance companies exceeded total obligations (including pension obligations) by $61 billion. Corporate stock holdings of life insurance companies totalled $91 billion, or just 9.7 percent of total assets.[1] It is therefore unlikely that the stock market decline seriously threatened the security of insured pension reserves backed by general accounts.

Some private insured pension reserves invested in separate accounts may have been more adversely affected. Separate accounts were invested 43 percent in corporate equity in 1986, and a given separate account may be 100 percent invested in stock. However, equity investments in separate accounts accounted for just 9.1 percent of all private insured pension reserves in 1986. Therefore, while some private pension funds invested through life insurance companies may have suffered substantial losses due to the stock market decline (at least in the short run), most probably did not.

State and Local Government Retirement Funds

State and local government retirement funds, which held total assets of $561 billion on September 30, 1987, suffered capital losses of $54 billion on their corporate equity holdings during the fourth quarter. Capital gains and losses on other investments of these funds cannot be estimated, because FRB data (on which these estimates are based) value non-equity assets at cost rather than market value. These funds realized interest income and dividend payments of more than $10 billion during the fourth quarter.[2]

The Impact on Plan Sponsors and Participants

While the preceding material suggests that the market decline (when viewed in

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[1]American Council of Life Insurance, Life Insurance Fact Book Update (Washington, D.C.: American Council of Life Insurance, 1987).

[2]Interest and dividends from U.S. Department of Commerce, Bureau of Census, Finances of Selected Public Employee Retirement Systems (Washington, D.C., April 1988). Capital loss based on Flow of Funds data calculated by EBRI.

context of the entire year's results) had an insignificant impact on the pension plan system in aggregate, additional questions concerning the effect on individual plan sponsors and their plan participants remain. It is important to note that the relative impact of October's results depend in large part on the manner in which investment risk is shared between plan sponsors and plan participants[3]. While there are several plan design considerations, such as the availability of lump-sum distributions, that affect the allocation of risk, it is determined primarily by the type of pension plan (defined benefit or defined contribution) selected by the sponsor.

Under the defined benefit plan the employer provides a specified benefit, usually related to an employee's length of service and/or pay. Under this approach, the employer's cost is whatever is necessary to provide the benefit specified. Under the defined contribution approach, the employer's contribution is specified. A defined contribution plan can involve a specific contribution (as in a money purchase pension plan), or it can take the form of a profit-sharing, thrift or savings, or employee stock ownership plan. Contributions are accumulated in individual participant accounts. A participant's benefit amount varies with the level of contributions, age at entry, retirement age, and investment earnings (or losses).[4]

The effects of the market decline on defined benefit plan sponsors are complicated and multifaceted. The next portion of the testimony will discuss individual components of the overall impact including the impact of the Pension Benefit Guaranty Corporation, the minimum funding standard revisions introduced by the Omnibus Budget Reconciliation Act of 1987, the new pension accounting standards mandated by the Financial Accounting Standards Board, and investment strategies including portfolio insurance. Effects on defined contribution participants are then discussed including cash or deferred arrangements and employee stock ownership plans.

Benefit Security for Defined Benefit Participants

Since the participant's benefit amount in a defined benefit plan does not depend upon the investment experience of the plan assets, any immediate losses to such a plan resulting from the October decline will be borne by the sponsor unless the plan terminates in an underfunded status.[5] If an underfunded termination

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[3]It is also possible to distinguish plans by the source of employer contributions to the pension plan (i.e., private versus public pension plans). While this section deals primarily with issues relating to private plans covered under ERISA, one survey has found that according to the pension executives of 29 of the nation's largest state and municipal funds, the equity positions of the funds were generally below the maximum levels allowed before the October stock market decline. Most of those interviewed indicated their funds are maintaining a conservative equity stance at a time when others are increasing their equity stakes to take advantage of reduced stock prices. For 20 funds surveyed, equity exposures have been limited by the respective state or local governments. The median maximum equity position allowed in the funds was 50%, but the stock exposure of the median fund was just 40%. Of the 9 remaining funds, the median equity was 35%. Jacqueline Dutton and Fred Williams, "Public Funds Survive Market Decline: Cautious Equity Stance Limits Damage/Two Smell Trouble, Sell Stocks," Pensions & Investment Age, November 30, 1987, pp. 47-48.

[4]Although only the two polar cases in selecting a pension plan are discussed here, it is important to note that in recent years several employers have been adopting plans that combine the best features of both approaches.

[5]A defined benefit pension plan termination is referred to as insufficient if the market value of plan assets is less than the present value of all benefits guaranteed by the PBGC. Underfunded terminations are only permitted if certain distress criteria (e.g., liquidation or reorganization in bankruptcy) are met.
Although a plan's guaranteed benefits will be closely related to its vested benefits, they will differ due to the maximum monthly limitation on insured amounts (currently $1909.09) and ERISA Section 4022(b) which provides for the gradual phase-in of insurance coverage to make the program less subject to abuse from newly established or recently liberalized plans. Vesting is a legal concept

does take place, the Pension Benefit Guaranty Corporation (PBGC) insures a certain level of the nominal vested benefits for the majority of defined benefit plan participants. Thus to the extent that the PBGC remains solvent (at least on a cash flow basis) there is little immediate impact on the plan participants.

Based on fiscal year 1987 figures, there does not appear to be any immediate concern for the solvency of the PBGC as a result of the market drop, especially after the modifications to the single-employer component of the system enacted by the Omnibus Budget Reconciliation Act of 1987.[6] The changes included an increase of the per-participant premium from $8.50 to $16.00 and the introduction of a variable rate premium based on the amount of underfunding for the plan. A full assessment of the impact of the market decline on PBGC's expected claims would require a detailed analysis based on plan funding ratios and estimated probability of termination.[7] However, the increased exposure faced by the PBGC as a result of the decline has been documented in two studies. The U.S. Department of Labor produced preliminary estimates of the changes in the assets and liabilities for single-employer, defined benefit pension plans from December 31, 1986 to October 19, 1987. The results indicate an overall decrease in surplus assets (assets minus liabilities) of $41 billion to $177 billion (a decrease of 18.8 percent).[8] The other evidence, a study by Salomon Brothers, found the average funding ratio of the 500 largest corporations shrank from more than 200 percent at the beginning of October to 166 percent by the end of the month; however, this is well above the 143 percent funding ratio seen at year end 1986.[9]

Another potential impact of the market decline on benefit security results from the fact that the vast majority of private defined benefit pension plans promise a benefit stated in nominal terms after the benefit accrual period ceases (i.e., no post-employment inflation protection). If the plan does not terminate and the sponsor remains profitable it appears to be quite likely that at least a portion of the impact of post-retirement inflation will be indemnified on an ad hoc basis.[10] A severe reduction in the level of pension assets could postpone cost of living adjustments for retirees and perhaps cause sponsors involved in collective bargaining agreements to take a harder line when negotiating new or improved benefit plans for current workers.

Accounting Implications for Defined Benefit Pension Plans

FASB Statement No. 87, Employers' Accounting for Pensions (FASB 87) establishes standards for financial reporting and accounting for an employer that offers

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that defines what percentage, if any, of the participant's accrued benefits attributable to employer contributions are nonforfeitable. Since the implementation of ERISA, the longest period of service that can be required for 100 percent vesting was 15 years.

[6]The fiscal year 1987 figures do not include the impact of the market decline on the equities in the PBGC portfolio (estimated to be in the range of $146 million for the first 26 days of October). The effect of the market activity is minimal however in comparison to the potential impact of an adverse legal decision in the dispute with the LTV Corporation over who should pay for the company's $2 billion pension fund shortfall. See Cynthia F. Mitchell and Ann Hagedorn, "LTV Pension Fund Case Goes Unresolved As Judge Rules More Evidence is Needed," The Wall Street Journal, June 12, 1988, p. 10.

[7]The methodology is explained in detail in Jack L. VanDerhei, "An Empirical Analysis of Risk-related Premiums for the Pension Benefit Guaranty Corporation," Report to the Pension Benefit Guaranty Corporation, June 1988.

[8]Ray Schmitt, Effect of Stock Market Downturn on Pensions, Congressional Research Service, December 29, 1987, p. 11.

[9]Hilary Rosenberg, "Going on the Defensive," Institutional Investor, January 1988, pp. 60-62.

[10]See Steven Allen, Robert Clark and Daniel Sumner, "Post-Retirement Adjustments of Pensions," Journal of Human Resources (1986), pp. 118-137.

pension benefits to its employees. The new accounting requirements mandated by FASB 87 are phased in with a two step process. The income statement (expense) provisions must be applied for years beginning after December 15, 1986 while the balance sheet (liability) provisions must be applied for years beginning after December 15, 1988. If the present value of plan liabilities, ignoring future salary growth, is greater than the market value of plan assets, employers must recognize a balance sheet liability equal to the unfunded amount (including unfunded accrued pension cost).

The prospect of including a pension liability on the body of the balance sheet has prompted some sponsors to consider altering at least a portion of their pension asset allocation from equities to bonds in a manner that would ensure at least a minimum amount of surplus for the plan. Likewise, a significant decrease in the plan's funding ratio would provide an incentive to forgo any further benefit liberalizations until the plan was restored to a surplus position. Although asset levels decreased significantly as a result of the October market decline, this effect can not be viewed in isolation as plan sponsors were at least partially insulated from the eventual balance sheet impact by a corresponding increase in the interest rate used to compute the present value of liabilities in 1987. This is due to the fact that FASB 87 provides much more guidance than its predecessors with respect to the interest rate assumptions chosen by the plan sponsor. In essence, the assumed discount rate must reflect the rates at which the pension benefit could be effectively settled. In other words, a "market value" of the termination liability must be calculated. Fortunately for plan sponsors, the PBGC (immediate) close-out rate increased from 7.5 percent at the beginning of 1987 to 8.25 percent at the end of the year.[11]

Implications for Defined Benefit Contributions

Although a decrease in pension assets levels will generally result in an increase in required minimum pension contributions, it is impossible to predict how firms will be affected because of the variety of methods permitted for smoothing market value fluctuation. An asset valuation method will be acceptable to the Internal Revenue Service for funding purposes if it produces an actuarial value of assets that is between 80 percent and 120 percent of fair market value.[12] Moreover, the cash flow impact of the market decline depends on the type of actuarial cost method adopted.[13]

Contrary to some reports, it appears that the new minimum funding standards enacted by the Omnibus Budget Reconciliation Act of 1987 will not accentuate the increase in the minimum required contribution for underfunded plans. An additional funding charge equal to the excess of the deficit reduction contribution (primarily an 18 year amortization of existing unfunded liabilities measured on a termination basis) over a portion of the minimum funding contribution otherwise required by ERISA (primarily 30 or 40 year amortization of unfunded past service costs) will be required for underfunded plans for plan years beginning after December 31, 1988. However it appears that, with few exceptions, this will not impact existing plans until such time that they are

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[11]Although not the only determinant of the interest rate assumption under FASB 87, it is appropriate to consider rates used to price annuity contracts that could be used to settle the pension obligation (including the rates used by the PBGC to value the liabilities of terminating pension plans).

[12]Treasury Regulation Sections 1.412(c)(2)-1(b)(4)(i) and 1.412(c)(2)-1(b)(6).

[13]Some actuarial cost methods (unit-credit, entry age normal and individual level premium) provide an explicit amortization component while others (frozen initial liability, attained age normal and aggregate) attribute a portion of the normal cost to amortization of gains. See Arthur W. Anderson, Pension Mathematics for Actuaries, (Wellesley, Massachusetts: The Windsor Press, 1985), p. 86

liberalized by the sponsors.[14]

Investment Issues for Defined Benefit Pension Plans

A major factor determining the extent of the short term impact of the market decline on defined benefit pension plans is whether the sponsors took advantage of the fact that they generally have more opportunity to sit out this type of market movement than other investors. This is due to the fact that most defined benefit pension plans have a positive cash flow as well as significant cash reserves and do not necessarily have to rely on selling securities to meet cash needs.[15] A survey of 48 of the largest managers of tax-exempt assets shows that pension fund money managers were not selling on October 19. Between that day and the end of November, more than 60% of the money managers reported they had been net buyers to varying degrees, and only 17% were net sellers. Only 3 of the 48 managers surveyed, including one major vendor of portfolio insurance, sold into the decline, and 7 did some buying on the day of the decline. Many of the respondents neither bought nor sold for the first day or two after the decline, and others took advantage of sharply lower equity prices.[16]

The long term impact on pension investment decisions will depend on future asset allocation practices. Although the rebalancing of portfolios appear to be a natural consequence of companies striving to meet target equity allocations that have been exceeded by the strength of the five-year bull market, the apparent degree of conservatism produced by the decline was dramatic. A Pensions & Investment Age survey indicates that the 1,000 largest pension funds might have reduced their long-term commitment to the stock market by as much as $10 billion following the October 1987 market decline. Of the 173 respondents, 7.5% had made "significant shifts in their long-term asset mixes in the wake of the crash."[17] On average, these funds had reduced their long-term equity commitments by 8 percentage points, much more than the previously mentioned EBRI/FRB results of large defined benefit pension plans for the entire fourth quarter of 1987 (3.6 percent).

Portfolio Insurance[18]

Portfolio insurance, perhaps the most controversial aspect of the market decline, represents an alternative to active asset allocation strategies. By 1987, fund managers had bought coverage for more than 60 billion of assets; at the beginning of this year only half of that remain covered. Although much has been written on this topic in the academic and financial literature, five basic questions appear relevant for this discussion:

1. what is it

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[14]One reason for this apparent contradiction (i.e., an 18 year amortization producing a smaller amount than a 30 or 40 year amortization) is that the latter amortization period is applied to a liability which reflects expected future pay increases while the 18 year amortization period is applied to a liability amount that reflects the obligations of the sponsor if the plan was terminated immediately.

[15]"Impact of the Stock Market Drop on Employee Benefit Plans," BNA Pension Reporter, October 26, 1987, pp. 1401-3.

[16]Joel Chernoff, "Managers Didn't Sell on 'Black Monday'," Pensions & Investment Age. November 30, 1987, p. 1.

[17]Joel Chernoff, "Equity Market Exodus: $10 Billion Cut Could Be Legacy of Crash," Pensions & Investment Age. February 8, 1988, p. 1.
Individual responses to the asset allocation issue were at times even more pronounced. In mid-November, Rockwell reportedly told its managers to liquidate all their stock holdings which had comprised an estimated 75 percent of the $6 billion fund. At the same time, Boeing reportedly purged most of the fund's stocks. Hilary Rosenberg, "Going on the Defensive," Institutional Investor, January 1988, pp. 60-62.

[18]Portions of this section originally appeared in Everett T. Allen, Jr., Joseph J. Melone, Jerry S. Rosenbloom, and Jack L. VanDerhei, Pension Planning, 6th ed., (Homewood, Illinois: Richard D. Irwin, 1988).

2. how was it used before the October market decline
3. was it successful during the October market decline
4. what is the market for portfolio insurance for defined benefit pension plans today
5. what is the likely future of portfolio insurance for defined benefit pension plans

Portfolio insurance is a device used to protect the value of the portfolio in the event of a significant market decline without giving up the potential to benefit from rising markets.[19] Although numerous variations of this approach exist, it is basically implemented through one of two approaches: dynamic hedging or transactions in the financial futures markets.

It should be noted at the outset that there is nothing intrinsically unique about a device that reduces the risk of a pension plan portfolio. Indeed, this decision is often made implicitly in the asset allocation stage. An investment manager could easily decrease the riskiness of the portfolio by 50 percent by lowering the active asset allocation from 100 percent to 50 percent (and leaving the remainder in a risk-free asset such as T-bills). However, this strategy would automatically result in a proportionate decrease in the portfolio's expected return. In contrast, portfolio insurance offers a combination of financial instruments that will--at least in theory--truncate the distribution of possible rates of return at some pre-specified minimum floor return (e.g., no more than a 15 percent decline during the next year). There is obviously a cost associated with such a "guarantee"; although in the case of portfolio insurance, it can be conceptualized as a constant cost (as opposed to a cost that is proportional to the rate of return the portfolio would have otherwise produced) in the region above the minimum floor return.[20]

Portfolio insurance may be created by dynamic hedging strategies that periodically adjust a portfolio's asset allocation between active and risk-free assets.[21] Based on the level and term of protection desired, an initial active allocation is established. It is then adjusted in response to changes in portfolio values and the passage of time. Portfolio insurance is not a market timing technique, there is no attempt to forecast returns. In rising markets, an increasing percentage of the portfolio is allocated to active assets; in declining markets, an increasing percentage is allocated to reserve assets. Under extreme conditions, the portfolio may be allocated entirely to either active or reserve assets.

Alternatively, portfolio insurance may be implemented by indirectly changing asset allocations through the financial futures markets. As the market declines, more financial futures are sold short against the equity assets insured. The profit generated from these sales is presumed to offset the losses on the pension plan assets. Conversely, as the market rises, these contracts can be removed.

Theoretically, both forms of this technique offer two advantages to a plan sponsor. First it enables pension funds to retain most of the asset gains they achieve when the markets move upwards, yet also enables them to limit their losses when the markets fall. This may be done with or without regard to timing considerations. For example, it could be used only at times of perceived market vulnerability. It also allows portfolios to be invested more aggressively.

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[19]Hayne E. Leland, "Who Should Buy Portfolio Insurance?" Journal of Finance, (May 1980), pp. 581-594.

[20]This cost does not materialize directly; instead, it can be thought of as the opportunity cost of having a portion of the pension plan assets in risk-free assets at the time of a market increase. The cost will obviously be positively associated with the degree of protection desired. In other words, a "guarantee" that the portfolio will not decline by more than 15 percent in one year will require less activity than one which permits no decline at all in the same time period. Perhaps less obvious is that the cost should decline as the term of protection is lengthened. For more information, the mathematically-inclined reader should see Simon Benninga and Marshall Blume, "On the Optimality of Portfolio Insurance," Journal of Finance, (December 1985), pp. 1341-1352.

[21]John R. Meneghetti, "Portfolio Insurance: Finding the Right Balance," Pension World, September 1986, p. 36 ff.

If the process is implemented through financial futures, other advantages may also exist:[22]

1. It is cheaper and easier to employ than to trade sizable blocks of stocks and bonds because the commission of futures contracts are lower than those on stocks.
2. It continues to reduce exposures to the market's vagaries as the market drops by short selling more and more futures contracts.
3. It lets pension fund portfolios remains undisturbed.

With a portfolio insurance program in place, it is expected that pension portfolios would take on a less conservative investment posture. Indeed this was the case prior to the October market decline as pension funds using portfolio insurance had a larger percentage of their assets in equities than those not using the strategy. The 80 respondents to the survey produced by the Presidential Task Force on Market Mechanisms (the Brady Commission) had an average of 45 percent of their assets in equities as of September 30. Of those, 11 were using portfolio insurance and had an average equity allocation of 56 percent.[23]

It appears safe to conclude that portfolio insurance was not universally successful during the market decline, however. The chairman of Leland O'Brien Rubenstein (LOR), the firm that pioneered portfolio insurance, estimates that a typical fund insured by his firm took losses of two to four percentage points beyond the promised limit due to discontinuities between the Chicago Mercantile Exchange (where futures contracts tied to the S&P 500 index are traded) and the New York Stock Exchange (where the market determines the price of the stocks that make up the index).[24]

The post-October market for portfolio insurance appears to be characterized by increased prices.[25] However, alternatives to portfolio insurance are expensive too: a static mix with a lower stock component would cut the investor out of the higher long term returns expected from equities, and strategic asset allocation and other timing approaches are likely to misjudge a large part of the market volatility. Some pension funds that discontinued portfolio insurance after the stock market decline in October have tried to reduce market volatility in other ways such as reducing the equity exposure of the portfolio. Some executives have stayed with the allocations they had while using portfolio insurance, indicating they had not assumed extra risk because of the hedging strategy.[26]

When portfolio insurance faced its first real test during the October decline, it failed miserably in the judgment of some commentators. Furthermore, regulators were investigating charges that portfolio insurance was a major cause of the market's fast drop. Disillusioned, such pension sponsors as Honeywell, Mead Corp., and San Diego Gas & Electric Co. suspended or canceled

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[22]Ralph L. Knisley, Jr. "Portfolio Insurance: Will the New Importance of Surplus Management Change the Strategy of Fund Managers?" FE Manual, April 1987, pp. 82-83.

[23]Barry B. Burr, "Restrictions 'Poor Medicine': Pension Execs Greatly Favor Free Market," Pensions & Investment Age, Feb 8, 1988, pp. 13-14.

[24]However, Wells Fargo investment advisers, another large purveyor of portfolio insurance and a licensee of LOR's technique, claim to have provided protection within a fraction of a percentage point of the level clients expected.

[25]In mid-November, Bankers Trust calculated that a one-year plan with a -5 percent floor would then cost between 4 and 6.25 percent in lost upside capture. Earlier in the year that plan would have cost 2 percent. Mark Voorhees, "Can Portfolio Insurance Make a Comeback?," Institutional Investor, January 1988, pp. 57-58.

[26]The Burlington Industries Inc. pension fund switched all of its equities to cash in November in order to lock in gains. The San Diego Gas & Electric Co. pension fund has continued selling stock index futures to hold down its equity exposure. Some of the funds that have retained portfolio insurance are contemplating changes in long-term asset allocation. Trudy Ring, "Risks Hedged in New Ways," Pensions & Investment Age, April 18, 1988, p. 3.

their policies. For pension committees, the main questions now concerns whether the cost of portfolio insurance has become prohibitive and whether it will work in volatile markets. However, LOR is apparently ready to respond to these criticisms by providing longer term policies that require less trading and that will protect, if not total equity portfolios, at least the surplus of pensions funds.[27]

Defined Contribution Pension Plans

The impact of the market decline on defined contribution pension plans depends on the types of investments offered and whether lump sum distributions are provided. Participants in defined contribution plans will see the results of fallen prices in their accounts, although the losses of October 1987 should be offset by the large gains of the previous nine months. Those about to retire may suffer if they cash out their accounts in the near future, and therefore might consider remaining employed for another year or two.

Many 401(k) plans also were adversely affected by the decline, since they are often significantly invested in company stock and equity pools.[28] Pension executives may begin to reconsider the options provided. Such options might include a highly diversified balanced fund or use of more guaranteed investment contracts.

ESOPs

The extent of the losses was greater for plans with a higher investment in publicly traded stocks; possibly the most affected were employee stock ownership plans (ESOP) that contain only such stocks. Most ESOPs have investments in closely or privately held companies. Six ESOPs that own 30 percent or more of their companies' publicly traded stocks suffered a total paper loss of $410 million between October 15 and 27. FMC Corporation, which held 32 percent of the company shares outstanding on June 30 was estimated to lose $239 million.[29]

The Tax Reform Act of 1986 contained provisions that, over time, will offer those ESOP participants nearing retirement age an option to diversify their investment portfolios. An employee who is at least 55 years old and has completed ten years of ESOP participation must be permitted to diversify up to 25 percent of his or her account balance at the end of the year less amounts previously diversified; after five additional years he or she must be permitted to diversify up to 50 percent less amounts previously diversified. It should be noted, however, that this provision is effective only for stock acquired after December 31, 1986.

An employee is entitled to make this election during a five year period. This period begins with the plan year of the ESOP following the later of (1) the plan year in which the employee attains age 55 or (2) the plan year in which the employee completes ten years of participation in the ESOP. The election period ends in the plan year following the fifth such plan year. The ESOP is required to allow participants to make the diversification election within 90 days following the end of the plan year.

The ESOP will either have to provide at least three investment options that are not inconsistent with regulations issued or elect to distribute an amount to the participant not in excess of the maximum amount which the participant could elect to have diversified. Such a distribution must be made within 90 days following the end of the diversification election period.

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[27]Mark Voorhees, "Can Portfolio Insurance Make a Comeback?," Institutional Investor, January 1988, pp. 57-58.

[28]A survey of more than 1,000 executives responsible for employee benefit funds at 1,400 of America's largest corporations found that 48 percent of 401(k) assets were invested in domestic stock, including company stock which accounted for 28 percent of all assets for these plans. See Greenwich Associates, More Policy, Less Tactics, Large Corporate Pensions, 1988, p. 48.

[29]Jacqueline Dutton, Nicky Robertshaw, "ESOPS Take a Bath -- Market Socks Defined Contribution Plans," Pensions & Investment Age, November 2, 1987, p. 8.

Conclusions

In the aftermath of the stock market decline, a number of conclusions can be drawn.

- It appears that the majority of pension funds were not involved in the October decline.
- The aggregate level of pension funds at the end of 1987 exceeded the level established at the end of 1986.
- Net sales of equities was not unusually large when viewed in a time series perspective.
- Investment gains produced in the first three quarters of 1987 more than offset the losses recognized in the fourth quarter of that year.
- Direct holdings of equities by pension funds declined marginally in the fourth quarter of 1987.
- Portfolio insurance, as implemented by some firms, was not completely successful in limiting equity losses during the market decline.
- It appears that the majority of pension funds did not have portfolio insurance programs in place during October 1987.
- The overall impact of the market decline can not be viewed in isolation. Trustees are simultaneously responding to incentives created by increased volatility in the financial markets as well as the pension accounting practices mandated by the Financial Accounting Standards Board and several new provisions enacted by the Omnibus Budget Reconciliation Act of 1987, including a new exposure-related premium for the Pension Benefit Guaranty Corporation, more rigorous minimum funding standards for underfunded plans and a more restrictive full funding limitation for overfunded plans. The net effect of these changes may be to make trustees more conservative as to investment management.
- Defined contribution plan participants suffered short-term losses to the extent their investments included equities. ESOP participants may have suffered the largest losses. Unfortunately, the diversification requirements added by the Tax Reform Act of 1986 have not been in force long enough to be of any real value to ESOP participants nearing retirement age.

Chairman PICKLE. Thank you, Mr. VanDerhei.

Are the pension funds fully recovered by now from the last October stock market crash?

Mr. VANDERHEI. No, although they realized an 8.4-percent rate of return in the first quarter of 1988, we have not yet reached the previous levels.

Chairman PICKLE. Did I understand you to say they had lost about $135 billion?

Mr. VANDERHEI. That is correct.

Chairman PICKLE. Because they made profit the first three quarters that offset that last quarter loss?

Mr. VANDERHEI. Yes.

Chairman PICKLE. Have they changed their investment practices since the stock market crash, since Black Monday?

Mr. VANDERHEI. To the extent that our data shows the aggregate practices, there has been a marginal decrease in equity holdings but much of that is indeed due to the fact that the market value of those equities have declined.

Chairman PICKLE. Equity holdings, you are talking about stocks and bonds?

Mr. VANDERHEI. No, we separate out bonds.

Chairman PICKLE. That means that when the crash occurred, and it was going down so rapidly, the fiduciaries were busily investing in the stock market to buy stocks that were going down that they thought would go back up; so, they were even heavier participants during the crash than they were before?

Mr. VANDERHEI. I believe the overall effect during the fourth quarter was no net contribution in equities by this class. There were definitely unrealized capital losses but no net sale.

Chairman PICKLE. But no net sales. I am trying to get that——

Mr. VANDERHEI. If you hold your existing portfolio while the market falls, you will have a lower value after the decrease even if you don't sell.

Chairman PICKLE. Earlier I had asked the agencies what kind of staffing they had to monitor these in excess of a million plans and I didn't get that answer. As I understand, they have 266 people down there to monitor these 1 million plans. Is that a sufficient staff in your judgment?

Mr. VANDERHEI. I imagine that would depend to a large extent on——

Chairman PICKLE. Mr. Delfico, do you want to take a swing at that?

Mr. DELFICO. I somehow expected that question after listening to the first page.

In my judgment, no, it is not sufficient to handle that load. We have looked at this problem in the past, as a matter of fact, at your request we have done some preliminary work in that area and by the measures we have used we think that staffing is not sufficient.

Chairman PICKLE. Do you believe that there is adequate monitoring by the Labor Department and the IRS of the investment practices of pension plans?

Mr. DELFICO. I believe that they have a promising plan to monitor the investment practices. I think they installed it in 1986 if I

am not mistaken. We have yet to see any results so I can't really comment on it.

Again, I think you may be faced with a shortage of adequate staff in the Department of Labor.

Chairman PICKLE. Have any of those agencies requested more personnel for these programs?

Have they diverted their own funds for it?

Mr. DELFICO. I am not sure of that. I have Mr. John Hansen with me who helped perform the investigation. Maybe he knows.

Mr. HANSEN. I am John Hansen. The labor shortage at the Department of Labor in the pension and welfare benefits area has been the subject of a number of studies over the last 10 years. The shortage of personnel in that area has been a longstanding problem that we have recognized.

To the best of my knowledge, they have not requested additional staffing nor has the Department of Labor shifted staff within itself to increase the number of people in that area. But it is a problem that has been greatly studied over the last 10 years and I am not sure what more has been done about it.

Chairman PICKLE. I am overwhelmed by the fact that here are these pensions valued in excess of $1.4 trillion—that is almost more money that we have in this country, and the fiduciary has tremendous power in his hands for investments, for sales, for purchases.

They are insured. So I am not saying the system is weak or the system is not correct. But it seems to me like we are having a very small number of people monitoring the largest sum of money we have in America, and I just wonder why more safeguards are not imposed on it.

I would assume the only way we will know what assets are in a fund is if we were to examine a form 5500 at the end of the year and that gives you information by category investment, but any time during the year we will not know. The only way anybody would know what is in those funds would be to go down and look at the forms from last year which may or may not have been monitored.

I was shocked to find out that on disqualifications IRS said less than 100 plans had questions about them. Now he gave me three examples of fraudulent filings and I thought, well, maybe that happened last month.

Those three cases happened in the last 7 or 8 years. That is not a very good up-to-date figure to give me for this committee to go back and tell me what bad things happened 7 or 8 years ago, although I don't question that they did happen and they should have been disqualified.

I would say to you and I am going to say also to Treasury, this is the first of a series of hearings on pension and pension assets and their investments and the monitoring of them.

This committee has decided that we ought to look into this in some depth and we will be doing that. We will have additional questions for you to find out the solvency of these different systems.

I personally am very concerned about it. So you can expect members of this committee in your backyards from now on. That will be appropriate, I think.

Mr. Schulze, do you have any questions?

Mr. SCHULZE. Mr. Chairman, I thank you, but I have no questions at this time.

Chairman PICKLE. Mr. Anthony?

Mr. ANTHONY. Yes, I do. This would be to Mr. VanDerhei. Could you tell me what the net gain or loss of the stock FMC Corp. was for the first 9 months of 1987?

Mr. VANDERHEI. I don't have the figure for the first 9 months at this time, but I could provide it for you.

Mr. ANTHONY. I wish you would because in your testimony you did provide the number for the loss during the October 15 timeframe through the October 27 timeframe in order to come to one of your conclusions.

[The following was subsequently received:]

NET GAIN OR LOSS FOR SIX ESOPS THAT OWN 30 PERCENT OR MORE OF THEIR COMPANIES' PUBLICLY TRADED STOCK

ESOP sponsor	Stock price—		Dividends	Net gain	Percentage gain
	Jan. 1, 1987	Oct. 1, 1987			
FMC Corp	$26.50	$57.38	$0.00	$30.88	116.51
Lowes Cos. Inc	26.00	25.00	.32	(.68)	-2.62
Colt Industries	10.00	14.25	.00	4.25	42.50
Transcon Inc	8.50	4.50	.00	(4.00)	-47.06
Michigan National Corp	33.50	45.50	1.00	13.00	38.81
CF&I Steel Corp	3.44	6.25	.00	2.81	81.82

Mr. ANTHONY. Also, based on your conclusions, you indicate ESOPs ownership could have suffered the most, yet you don't go in and substantiate that conclusion with numbers. I wish you would do that for me.

I happen to have been the author of the provision that you bragged about. I am a very, very strong supporter of ESOPs. Doing some quick figuring on page 9 of the six ESOPs that you say owned 30 percent or more of their companies' publicly traded stocks suffered a total paper loss of $410 million between October 15 and 27, FMC represents 239 million of that, so five others shared $171 million paper loss.

That doesn't seem at first blush to be anymore disturbing than the 80 percent decline that Mr. Delfico talked about in other plans. I finally found out who my constituent was that was complaining to me about this. It was a guy who lives next door to the guy whose plan went up 45 percent and his plan went down 35 percent.

The other guy is happy as hell. I finally figured it out. That is an 80 percent swing. That is staggering. So if you could, because also in your same statement, in that same paragraph about ESOPs you make the statement that most ESOPs have investments in closely or privately held companies which were not affected directly by the stock market crash.

So there seems to be a contradictory statement in your conclusion on ESOPs. All I am going to do is get them straightened out. I wish you would look at FMC and if you could take a look at the value of those other companies before and after.

I would like to see if there has been net gain or loss. I would like to see how they compare because both of you were very good about showing about the first 9 months and how they increased and that little blip didn't totally eliminate it but eroded it a great deal.

Unfortunately, most investors valued it the day before the crash. That is the money they had to spend so your averaging across-the-board doesn't give them a lot of comfort. It does bother them to the extent that—and the polls have reflected this—that every day since then there has been a great deal of concern about whether or not that could occur again. You talked about portfolio insurance and I think you made the statement that, I think this was in your testimony, Mr. Delfico, that the majority of the pensions that you examined did not have portfolio insurance. Did you back that up?

Mr. DELFICO. Yes, we found it roughly the same.

Mr. ANTHONY. Taking that as true, can you explain to me why both exchanges immediately outlawed portfolio insurance trading? That was the first thing that they did. It took them about two weeks.

Mr. DELFICO. There may have been other people who were heavily invested in portfolio insurance strategies that used program trading other than the pension investors. I can't comment on that.

Mr. ANTHONY. So you are saying that based on your studies afterward, that the pension investments would not be a part of that problem, if those exchanges had modified their internal rules to tighten it down?

Mr. DELFICO. We found that that was the case. We were surprised to find that not many pension plans were using hedging devices.

Mr. ANTHONY. I guess that is the reason you have public hearings, to ferret out the facts. Portfolio insurance and computer trading, are they synonymous?

Mr. DELFICO. No. Portfolio insurance is a strategy. Computer trading is a mechanism for implementing it.

Mr. ANTHONY. Maybe you better define what portfolio insurance is for me.

Mr. DELFICO. I am sorry but I don't have a good one.

Mr. ANTHONY. Maybe one of the staff could help.

Mr. VANDERHEI. Portfolio insurance can be implemented in many different ways but perhaps the least expensive manner of doing so was to sell financial futures during the market decline to try to provide a minimum rate of return for the overall pension portfolio.

I believe this had been introduced as early as 1984 in merely a trading off between cash and equities, when the equity market started to decrease you would see equities going to cash. Unfortunately, that had a tendency to be quite invasive as to the overall portfolio strategy.

If one can overlay an implementation of this type with computer trading of selling financial futures when a market declines, in theory when there is close tracking between the overall stock market and the value of futures one should have been able to maintain a certain minimum rate of return.

Unfortunately, the Merc and the stock exchanges went out of sync for a while during the 19th and 20th of October and sellers of

this strategy—portfolio insurance—either stopped selling financial futures or perhaps just modified their strategy sufficiently that they no longer were able to provide the minimum rate of return that the plan trustees thought they were going to receive from the strategy.

Mr. ANTHONY. Well, there were two lessons that I think the public learned as a result of this and maybe we need to do a little more investigation and make sure we have a very complete record on it.

No. 1, it put Chicago and New York at one another's throats, New York blaming Chicago for having created too many futures markets, and Chicago blaming New York for not having adequately pleased their own investment houses in terms of how they go about providing a market place.

Each finger pointing and then, as you know, we have had a multitude of hearings all over the Hill from various committees. The other thing that really struck my attention, and that would be the case if you did have the insurance in place and you actually triggered it, and that particular pension fund because of the sheer size of that pension fund had blocks of hundred thousand shares of stock, the poor sap in El Dorado, AR, who went in to Jones or whoever and said I want to get rid of my hundred shares, his order got lost.

Yet on a relative basis he may have been using that as his own retirement because he may have been in that 45 percent category who does not have an employer voluntary-provided pension fund, so he provided for his own and yet he got clobbered.

Here we are holding a hearing to take a look at what happens to the 55 that are protected but I am really curious as to whether or not the 55 ran over the 45 like a bulldozer as a result of a whole bunch of these market intricacies.

So anything that you have at your disposal in terms of what the impact was in the market, I think would be very good for this committee to have. I guess—I pick up the Washington Post and I basically look three places. I look at the headlines on the front page, I look at the sports page to see how my favorite team did and then I look at the stock page to see whether the stock market went up or down and then you try to figure out why.

It still has wild swings of large numbers without any coherent reason behind it. One day interest rates will be up, the dollar will be down and it will swing or vice versa. I think for those beneficiaries who have 40 percent of their potential cash out retirement funds in equity, I have to believe that they are going to be watching that stock market closer than they ever have before.

So the studies that we do and although you might not make specific recommendations, it will be the responsibility of this committee to make a report to the full committee and the full committee will have to decide whether or not there should be additional changes.

So what we are doing here is it is important and it is complex because it does have an impact on a great deal of individuals over and above direct beneficiaries. I think you have helped us. You have certainly given us a lot of food for thought. Can I just go home and tell that poor beneficiary of an 80 percent down swing

that he just has to blame it on the fiduciary of his pension fund and that is really about all that it amounted to, the guy next door had one that was smarter, quicker, read the tea leaves quicker or the stars——

Mr. DELFICO. That particular plan, if I recall, was a defined contribution plan where the participant directed his or her investment. Second, it was probably in company stock.

I am not sure about that, but I think that was company stock so it wasn't diversified, but that is allowed.

Mr. ANTHONY. I understand it is allowed. In terms of specific instances where you are talking about the highs and the lows, I think it would be helpful if we could have some of the fact situations. The fact situations may tell us more than just the raw conclusions about the highs and the lows.

Mr. DELFICO. We can do that for you.

[The following was subsequently received:]

In one example, a plan's assets increased 28 percent in the first 9 months, but decreased 27 percent during the fourth quarter and 6 percent for the year overall. The plan was a defined contribution plan which had about 17,000 participants and $400 million in assets as of January 1, 1987. Both the employer and the participants contributed to the plan, but investments were directed by the participants. The investment options available to the participants included investments in the sponsoring company's stock, a stock fund, guaranteed investment contracts, and cash equivalents. In 1987, the plan maintained a consistent investment position at the three points in time covered by GAO's survey—approximately 77 percent invested in company stock, 9 percent in guaranteed investment contracts, 8 percent in a stock fund, and 6 percent in cash equivalents. The increases and decreases in the value of plan assets were caused almost exclusively by changes in the value of the company stock held by the plan. GAO did not have additional information on the other example presented.

Mr. ANTHONY. It is sort of like curiosity killed the cat but satisfaction brought him back.

I would like to look at some of those. I would like to take a look at those as much as I would the ESOP.

Final question. Both of you seem to indicate that defined contribution plans suffered more on balance than defined benefit plans. Is there some rational reason for that that jumps out at you or your staff as you prepared this vast amount of data?

Mr. DELFICO. There are a couple of reasons why defined benefit plans perform better, the diversification we feel helped. They had their assets diversified, less than half in equities; the rest in bonds, real estate and other investments.

The more stable performers had a pretty good balance in their investment portfolios. The defined contribution plans that were at the extremes were generally the ones heavily invested in stock. Some of those that did poorly were heavily invested in company stock and less well diversified.

So those two things were what we saw in the data when we analyzed it.

Mr. ANTHONY. Mr. VanDerhei.

Mr. VANDERHEI. The one thing that I noticed was that defined benefit plans by and large started moving out of the equity market prior to the crash, whereas the participants of defined contribution plans oftentimes did not possess the same amount of "foresight" and thus they had larger percentages remaining in equities in October 1987.

Chairman PICKLE. Why would defined benefit plans start moving out of the equity market before the crash?

Mr. VANDERHEI. In many instances, the investment committee sets a target, a set allocation for equities. Then they experience a 5-year run-up in equity values. If you start at 40 percent and had 5 years of increase in equity value, you are no longer at 40 percent, everything else being equal.

Many of the investment committees decided to go back down to their target equity allocations and as a result had to start selling equities and going into bonds or whatever.

Mr. ANTHONY. Well, I think your testimony has been very fascinating. It has also probably created a little bit more curiosity for some more questions. I think I agree with what the chairman said—we will probably be back for another round as we try to get a handle on this.

Without question, both from an economic and a political standpoint, the area of pensions certainly coincides—it is a tough political issue and at the same time it is an enormous economic issue, and I think it is one we all have to take a very, very close look at it to see if there is a need for additional legislative or regulatory changes without creating an atmosphere where more plans will be cancelled rather than more plans being properly administered for the long-term retirement benefit of those plan participants.

I thank you, Mr. Chairman, and I thank the two witnesses. I yield back.

Chairman PICKLE. I am looking at this form 5500. Now, that is the only source of a tabulation or reporting of what a plan has invested in. They submit that to the Labor Department or to IRS?

Mr. DELFICO. IRS.

Chairman PICKLE. IRS gets that—you have 266 people, that means if you have a million-and-a-half plans, everybody has to be handling over 5,000. They are not all examiners—that means everybody has to examine 10,000 cases a year. On the surface that is shocking.

Here is this form. You list amounts of corporate debt instruments, you list amounts of corporate stocks. You do not have to say specifically where it is invested, whether it is in Edison, Ford or whatever it is. The form just says "stock."

Real estate, it could be in Afghanistan or Iran or Timbuktu or even in Texas. But that is all it shows. It just shows real estate.

Mortgages, period. Just the category. Loans. Now there is no way to list specifically where this investment is, and labor and IRS got in and you say, here is a fiduciary, and he says you have so much real estate. How do you pass judgment on whether that is good real estate?

You don't think that is your responsibility?

Mr. DELFICO. Our responsibility would be to oversee how IRS is doing that.

Chairman PICKLE. I don't have IRS here. But how can somebody down the street find out the details when a plan lists so much real estate. Is there an appendix to show where the real estate is?

Mr. DELFICO. No. The only way they could get that is through the plan itself and that is labor's responsibility.

Chairman PICKLE. Assume that I was a plan participant and I am uneasy about the stock market. Can I go in at any given date and ask my plan sponsor where my investment is. Can I find that out?

Mr. DELFICO. I would suspect you could, but it may take a while for them to get you the information.

Chairman PICKLE. I am not talking about how long. Is there a way for him to get that information? Do either one of you know? Can he go to his sponsor?

Would the sponsor have to tell him where that investment is?

Mr. HANSEN. Mr. Chairman, the plans that we are talking about, the very large plans do have investment policies that should be made available to the plan participants so they can find out what kinds of investments the plan makes.

Chairman PICKLE. I don't know that I am insisting that that be done. I think you could make the reporting so onerous that people wouldn't want to fool with it, it would run everybody crazy.

I accept that. Yet that fiduciary has every responsibility in the world. He is being held accountable, and all he has to do is say he is investing the money in a prudent manner and each question of prudence depends on facts and circumstance of a particular case.

We don't say that you can invest only 10 percent in real estate, only 20 percent in stocks, 20 percent in insurance and so forth; just whatever is prudent. It seems to me like that there are serious questions being raised. Do we give too much power to the fiduciary and the plan sponsor on where and how they invest his money?

The fact is that we haven't had more scandal. They say it is a good system and it is working and we don't have a problem here. But, whenever you have almost your entire national assets tied up in pension funds, you ought not to assume that.

It seems to me like these investment officers have got more power than the President and the Vice President and all his Cabinet put together regarding investment. They have more to do with the stock market than any group in America because they turn over money faster than anybody in America today.

I don't say that is bad in itself; but, I say that when we have this amount of money out there it seems to me we better start looking a lot closer and seeing what we have there.

That is why we are going to be looking at this thing further to try to understand whether we are just sleeping through this or are we really on top of it. We are going to submit other questions that we want answered.

This is the first of a series of hearings on this subject, and we will be back on this field later. I personally thank you for your information. We are not trying to say that there is a lot of fraud or slipshod practice going on. But when you consider the number of investments and all of it is workers' retirement funds, and that amount of money is involved is not matched in the world, we have got to look into this thing further.

So we will be doing that. Meanwhile, thank you very much for your testimony.

The hearing is adjourned.

[Whereupon, at 3:05 p.m. the hearing was adjourned.]

[A submission for the record follows:]

STATEMENT OF THE ESOP ASSOCIATION

July 29, 1988

Mr. Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Room 1102
Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

This is a written statement submitted by the ESOP Association for the record of the Oversight Subcommittee's July 12, 1988, hearing on "Investment of Pension Plan Assets". (As announced in Committee Press Release # 22.) The ESOP Association has sent copies of this written statement to the offices of the members of the Subcommittee. The signer of the statement is J. Michael Keeling, General Counsel of the ESOP Association and of Counsel with the Washington, D.C. law firm of Zuckert, Scoutt & Rasenberger, 888 17th Street, N.W., 202-298-8660.

This statement comments on the testimony of Jack L. VanDerhei and Joseph S. Piacentini as it pertain to ESOPs. Their testimony was presented on the letterhead of the Employee Benefit Research Institute (EBRI). The following appeared, however, on the testimony cover sheet: "The views expressed in this statement are solely those of the authors, and do not necessarily represent the view of the trustees and sponsor of the Employee Benefit Research Institute, or its staff". This testimony will be referred to as the VanDerhei statement.

On page 9 of the VanDerhei statement, reference is made to an article in the November 2, 1987, issue of the publication Pension & Investment Age, entitled "ESOPs Talk a Bath -- Market Socks Defined Contribution Plans,"

In that article, 6 U.S. corporations with ESOPs holding 30% or more of the corporation's stock are cited as evidence of the significant loss in value of participants' accounts in the ESOP. In particular, it is noted from the article that the FMC corporation ESOP suffered a $239 million loss in value between October 15 and 27, 1987. On page 10, the VanDerhei statement concludes that, as a result of the stock crash of October 15 to 17, "ESOP participant may have suffered the largest losses. Unfortunately, the diversification requirements added to the Tax Reform Act of 1986 have not been in force long enough to be of any real value to ESOP participants nearing retirement age."

The ESOP Association maintains that the VanDerhei statement presents an incomplete statement about the value of the ESOPs accounts in the six companies, and, albeit perhaps unintentional, sets forth the implication that ESOPs are bad for employees.

Addressing the six companies first, let's look at the facts.

The six companies are;

1. FMC Corporation, a diversified equipment manufacturing company;

2. LOWEs, a home retail/building supply company;

3. Michigan National, a bank;

4. Transcon, a trucking company;

5. CF&I, a steel company; and

6. COLT, a diversified company.

Because COLT was bought out on June 10, 1988, it is not used in the comparison chart below. (The COLT purchase, by Colt Holdings, was valued at $17 per share, as compared to the Colt October 27, 1987, value of $8 3/4 per share. This sale price represents a 49% gain for the ESOP participants in approximately 8 months.)

The following chart set forth the stock prices of the five companies that still have an ESOP, and the value of the stock on January 2, 1987, before the 1987 stock price run-up, the October 15, 1987 price, the October 27, 1987 price, the December 31, 1987 price, and the July 18, 1988, price. The chart then presents the percentage change in the price for 1/2/87 to 7/18/88 and 12/31/87 to 7/17/88. The dollar value gain or decrease of the ESOP stock is also set forth in approximate numbers, due to rounding.

	1/2/87	10/15/87	10/27/87	12/31/87	7/18/88	±% 1/2/87 to 7/18/88		±% 12/31/87 to 7/18/80	
1. FMC	26-1/4	48-1/2	33	33-1/2	37-1/4	+42%	($+120M)	+11%	($+41M)
2. LOWE's	26	23-1/2	17-1/4	16-1/8	21-7/8	-16%	($-40M)	+36%	($+55M)
3. Michigan National	33-1/4	47-1/2	37-1/4	41-1/2	46	+38%	($+57M)	+11%	($+20M)
4. TRANSCON	8-1/4	3-1/2	2-1/2	2-1/2	4	-52%	($-14M)	+60%	($+ 5M)
5. CF&I	3-7/8	6-1/4	4-3/8	3-1/2	7-3/8	+90%+	($+ 7M)	+111%	($+ 8M)
Average increased ESOP Companies						+20.4%		+ 45.8%	
Dow-Jones Average Increase in Same Period						+ 9%		+11%	

A full presentation of all the stock prices show that the VanDerhei statement, consisting of a snap-shot, short-term view of stock value, presents a distorted, and unfair picture of these five companies and their ESOPs

First, all the companies' ESOPs are increasing in value at an amazing average rate of 46% for 1988 (December 31, 1987 to July 31, 1988.) The Dow-Jones average increase over the same period of time is 11%. Clearly, the ESOP participants are benefitting more than if their assets were invested in a blue chip Dow-Jones diversified portfolio.

Second, three of the five corporations are ahead of the January 2, 1987, value, and the average increase of 20.4% for all five compares favorably with Dow-Jones average increase of 9%.

Ironically, the company the VanDerhei statement blasts by name has increased its ESOP account the most in dollar amounts.

The two companies which have a value decline from January 2, 1987, to July 18, 1988, LOWE's and TRANSCON, are not disaster stories.

LOWE's, long the leading ESOP company in America, has an impressive record of providing six, or even seven, figure retirement payments to average wage earners. LOWE's has documented the riches it has provided to its employees over and over, and national publications have sang its praises consistently. (See Robert Strickland, Chairman of LOWE's, statement to full Ways and Means Committee hearing on proposed tax reform, July 10, 1985.)

TRANSCON has faced the perils of trucking deregulation, which has literally eliminated may of its competitors. Its stock price appears to be rebounding, however.

Finally, the VanDerhei report implies that these ESOPs are not subject to improvement, because the Anthony ESOP diversification amendment (Code Section 401(a)(28)) became effective only in 1987. A disingenuous point at best. The congressional tax committees decided diversification was a positive enhancement of ESOPs in their role as ERISA plans, but Mr. VanDerhei dismisses the provision because Congress did not make this reform earlier.

The ESOP Association testified before the Oversight Subcommittee on ESOPs and retirement income security on September 6, 1985. At that time, the Association made a clear statement that ESOPs, invested primarily in the plan sponsor's stock, are not retirement plans if retirement income security is defined as a "guaranteed, level payment of benefit for the years after employment ceases". At the same time, we have provided the Congress with ample evidence that ESOPs can create significant and some times incredible amounts of wealth for ESOP participants, and that wealth, or money, by its definition, provides for income security.

In sum, we believe the VanDerhei statement presents a distortion to the Oversight Subcommittee, both as to the six companies criticized, and as to ESOPs in general.

Please contact me if you have any questions.

Sincerely yours,

J. Michael Keeling